

LL.M DISSERTATION - INTERNATIONAL TRADE LAW

Methods of payment and exporter's risk exposure

A view to exporter's payment risks and their management by different methods of payment during contracting for an international sale of goods.

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CHAPTER 1 - INTRODUCTION

Crucially important to a seller of any merchandise is to know, whether or not he will in fact be paid for the goods he ships to his buyer. The question becomes even more important when a foreign element is added to the transaction in the form of a buyer located in a far-away country about which no one knows too much. The exporter faces a risk of not being able to obtain the money due to him even if he himself has fulfilled his part of the bargain. Facing that problem he may end up using all sorts of methods and mechanisms to lower his risk exposure to an acceptable level, still realising, that the possibility of something going wrong cannot be eliminated completely. Some of the methods of payment risk management, which the exporter can employ, fall outside the realms of that agreement of sale which he has with the buyer and some, on the other hand, he must include into the contract itself. Different methods of effecting payment clearly belong to the latter group due to the fact that the parties always have to agree on some method of effecting payment, using which the buyer fulfils his part of the agreement.

My intention is, in this paper, to assess those different options from which exporter has to choose, regarding most common methods of payment in foreign trade. Emphasis will not only be put on the security factor but also on the economic point of view. The reasoning behind this is that the method of payment, used by the parties or in fact alternatively demanded by the exporter, clearly effects the payment security of the exporter, but also has an effect on the competitiveness of the seller in the world market.

It is submitted that it would be impossible to discuss a broad topic such as this without leaving something important outside the scope of the paper. That has been done in the context of this paper by leaving out all procedural aspects that do not have an effect on the exporters security of payment. Especially in the section that discusses documentary credits, the workings of the credit and banking procedures have been cut to minimum in order to include aspects that in my mind were important. It follows that this paper is in principle about the possibilities that an exporter has, to use methods of payment beneficially and economically during the period of drafting the contract of sale. Furthermore, it must be mentioned that by assuming that the exporter is a bona fide merchant I've decided to leave out the vast material and case law relating to the fraud exception in the context of documentary credits.

CHAPTER 2 - RISK EXPOSURE IN FOREIGN TRADE

1. Legal and other risks generally

' "Exporting is fun" declared the politicians in the sixties, attempting to encourage British firms to get in to export trade and to exhort firms already exporting to allocate more of their production for export. Far from being "fun", exporting is deadly serious, although a sense of humour and the ability to see the ridiculous are certainly useful in coping with the delays, frustrations, and unbudgeted expense incurred in selling abroad.'¹

All parties involved in a business transaction, local or international, face the risk of their transaction being unprofitable or less profitable than was planned. This can occur either, because the transaction did not progress according to the plan and the costs or some other unforeseen consequences of this event erode the margin of profit or, for the reason that the fundamental economic calculations which initially led to the decision to get involved in the particular transaction were inadequate or even wrong and the business profit never realises.

These uninvited possibilities of a transaction turning unprofitable can be analysed and estimated in a process of risk analysis which denotes a systematic investigation and forecasting of risks in business and commerce. In risk analysis the judgements of the experts involved are taken and translated into the language of probability which helps the party concerned to make reasonable decision.² The factors considered in this process are partly purely economical and bare no legal interest but there are also many factors with characteristically legal nature to be taken into account. These factors can be defined as legal risks of a commercial transaction. It is clear that the risk analysis and the overall risk management of a business transaction cannot be complete and effective without a careful assessment of the legal risks.

Although the legal risks of a domestic transaction are not laid out here in detail, it goes without saying that a commercial transaction with a foreign component to it attracts significantly more risks and from a legal point of view it could be said that cross border legal risks and issues are

¹ Edwards, 1.

² The Oxford English Dictionary, under -Risk.

emerging as a separate area of commercial risk that needs to be precisely identified and managed.³

In principle, an international sale is no different to a domestic one, but the parties are nevertheless subjected to additional risks not faced in the domestic arena. In international sales, according to Hugo, 'the seller not only faces the economic or commercial⁴ risk that the buyer, due to a lack of funds, insolvency, or the fact that he has found a better bargain elsewhere, is unable or unwilling to comply with his contractual obligation to pay timeously, but also the political risk that the buyer may be unable to comply with his obligations due to external factors such as war, revolution, blockage of funds or the cancellation of export or import licences.'⁵ In other words, an international seller on one hand faces risks relating to the buyer, ie. the performance risk (unwilling to perform) and the credit risk (unable to perform), and on the other hand, risks relating to and arising from the economic and political situation in the country of the customer.⁶ Furthermore the international seller faces risks such as the influence of exchange-rate fluctuations, the regulation of exchange control, and the risk of having to take legal action in the buyers jurisdiction in case the buyer defaults.⁷

The risks that the international buyers face are in a way a mirror image of the risks experienced by the seller. There is always the risk that the seller is unwilling or unable to comply with his contractual obligations and the buyer also runs the risk of being affected by the economical and political situation in the sellers country. Characteristically the buyer, being in a far-away country, runs risks which arise out of the difficulty of effective quality control. The buyer will thus require assurance that he will receive the specific goods contracted for. The considerable time involved in shipment may also cause cash-flow problems for the buyer.⁸

³ ALRC 80, 1.

⁴ Berman-Kaufman, 221-222..

⁵ Hugo, 2.

⁶ Lafili-Gevurtz-Campbell, 185.

⁷ Hugo, 2.

⁸ Ibid., 3.

2. Management of legal risks

The risks mentioned above should be considered and managed before a party to an international sale of goods agreement can be confident that the transaction won't be exposed to unpredictable risks of indeterminable magnitude inhibiting business activity and raising costs. Management of the legal risks aimed at reducing cross-border legal problems in foreign trade can only be successful and effective if the measures taken are focussed primarily on risk management rather than dispute resolution. Therefore emphasis should be put on generating the necessary level of comfort in the business relationship and on dispute avoidance so as to help in providing business opportunity rather than simply solving problems after they have occurred. In international trade contracting this should translate into prudential safeguards and secure payment systems.⁹

Players in international commerce have a variety of choices before them when deciding how to manage the legal risks involved in their particular course of business. The simplest alternative is to take the risk without any measures of compensation or protection. Second option is to price the increased risk into the fees or return the party concerned requires.¹⁰ Thirdly, the person running the risk might choose to transfer the risk to a independent third party - for example an exporter may transfer payment risks to a bank by using documentary credits. Other variations of the third option are bank guarantees and commercial insurances. Both of the two transfer the risk of a non-performance to a party not involved in the transaction. Yet another way of managing the legal risk is to try to avoid the impact of a foreign, possibly unknown, legal system on the transaction. This can be achieved by choosing a forum for possible future litigation and furthermore by choosing a particular legal system which will govern the transaction should any disputes arise. Alternative dispute resolution methods can also be employed in order to avoid these risks.

In international sales, exports, various measures mentioned above can be taken in order to secure the transaction and they also can be employed in many different ways. One distinction is important in the context of sales contracting, namely the one that some of the methods are included in to the contract on which the transaction is based on, and others are employed outside

⁹ ALRC 80, 10-11.

¹⁰ Ibid.

the contractual relationship. First of all the parties can try to draft the contract in such way that it helps them to avoid some of the obvious risks in foreign trade. The seller for example can insist on taking advantage of the more secure payment methods which involve banks acting in between the parties or, he might want to secure the buyers performance by demanding him to organize a bank guarantee to back up his performance. Outside the contractual relationship and, of course, without the other party's contribution, the seller has the possibility of reducing his risk exposure for example by insuring himself against the risks. Also not to forget is the most important method of risk management in any foreign commercial operation, namely the acquiring of accurate credit information about the customer himself and the country of his origin.¹¹ This information can tell, directly or impliedly, about the degree and kinds of risks involved in a particular transaction and should be used as the basis for the use of any of those practical methods of risk management mentioned shortly above.

3. The payment risk

3.1 Nature of the risk

Payment risk in exports is in theory identical to the payment risk in domestic sales and sellers objective in international sales is also quite clear; to ensure that sales are paid for, and that they are paid on time. Schiller describes payment risk as the degree of probability with which the receipt of payment in the amount and at the time agreed upon is to be expected by the seller. The higher the probability, the lower the payment risk.¹² Understandably, the seller wants his money, but it is also very important that he gets it on time in order to avoid extra costs resulting from poor cash-flow¹³ and the additional interest expense on the extra borrowing to support the excessive receivables created by slow payers.¹⁴ It is also possible in a particular export situation that the parties have agreed that the terms of payment allow a waiting period between the sale

¹¹ Edwards, 97-106.

¹² Schiller, lectures.

¹³ Schiller states that 'cash-flow for the purposes of risk evaluation shall denote the relationship between a) the dates and amounts of payments received by the seller, and, b) the dates and amounts of costs incurred by seller including payments made by him to third parties (sub-supplier)'.

¹⁴ Edwards, 3.

and the time of payment. This waiting period requires investment of working capital, usually borrowed funds, with a risk of total or partial loss during the wait. If the payment after the waiting period is delayed even further, it most probably has the effect of eroding the intended profit.¹⁵

These facts are all relevant in both domestic and international sales but, assessment of the payment risk in exporting branches out to a new dimension when the factors having an effect on the risk exposure are considered. These variables are described by Todd: 'In exports, unlike in a domestic sale of goods, the parties deal from different jurisdictions and could be thousands of kilometres apart geographically, and never need to meet to conclude the transaction. The parties are also less likely to deal often with one another than in the case of ordinary domestic sale of goods. Furthermore, many international sale transactions are of a one-off nature. In these circumstances the parties probably have little or no knowledge of each other, and little reason to trust each other.'¹⁶

Considering the circumstances of exporting it can be concluded that it will be difficult for the seller to be certain about the actual financial standing of the buyer and that the debt incurred by the buyer will be settled once the goods have been dispatched to him. Secondly, the seller is at great risk if he decides to go through the trouble and expense of obtaining and consigning goods without assurance that he will eventually be paid for them. Once the goods have been dispatched and are at sea, the seller may have difficulties in getting them back should the buyer default on payment and he will probably be unable to recover his goods before they have arrived in the buyer's country of business.¹⁷ Exporting and the management of the payment risk get even more complicated when considering and acknowledging the fact that once the problem in payment has occurred, a civil remedy might not often be a realistic commercial option due to the expenses, complexity and slowness of cross-border litigation.¹⁸ Further conclusion then is that in any exports operation, the payment risks should be managed effectively and as

¹⁵ Edwards, 3.

¹⁶ Todd, 7.

¹⁷ Ibid., 7-8.

¹⁸ ALRC 80, 5.

comprehensively as possible in the contracting phase, before any complications are allowed to take place.

3.2 Exporters options in payment risk management

3.2.1 Secure methods of payment

From the exporters point of view, the most important consideration is to be protected against the consequences of bankruptcy of a purchaser about whose financial standing he knows nothing, or non-payment by that purchaser for any other reason. The choices that the exporter has range, as stated earlier, from payment methods which directly reduce the risk of non-payment, to bank guarantees and insurances which enable the exporter to obtain settlement from an independent third party in case the buyer defaults. Firstly of all, considering the various methods of payment, the obvious solution for the exporter would be to demand payment in advance. The buyer, in other words, must pay the seller before receiving anything. The risks inherent to such a sale are then absorbed by the buyer.¹⁹ This, however is not the method favoured by the international buyer and he, of course, will most likely be opposed to these terms of payment, partly for cash-flow reasons, but more importantly because 'in international sales there is no more reason for the buyer to trust the seller to ship the goods or cargo of the promised quantity and description, than for the seller to trust the buyer to settle his debt'.²⁰ For these reasons the seller might find it difficult to get a payment in advance- provision included into the contract between him and the buyer and this method of payment, which is most advantageous for the seller, is likely to be found only in transactions where the seller is, as Goode describes it, in a particularly strong bargaining position.²¹ More commonly, the exporter will try to secure the payment by means of documentary collections or documentary credits²². In the case of the former the exporter dispatches the goods to the buyer but maintains ownership and legal control over them. The title

¹⁹ Hugo, 3.

²⁰ Todd, 8.

²¹ Goode, 640.

²² Hugo about the terminology at 9: '...as a general rule it would appear that the term "letter of credit" is the more popular in the United States whilst "documentary credit" is favoured in the recent English sources.' He also concludes that both terms are synonymous. The Uniform Customs and Practice for Documentary Credits has adopted the latter expression.

documents referring to the goods will not be transferred to the buyer until the exporter has received payment or acceptance of a bill of exchange drawn by him. When letters of credit are employed the seller has a promise of a reputable bank that he will be paid after he has dispatched the goods of agreed description to the seller. Both of these methods have their shortcomings but, offer nevertheless much more security than the least secure of the widely used methods of payment, the 'open account' - payments. Here the seller dispatches the goods bound for the far-away country and trusts that the buyer situated in that country has the ability and motivation to settle his debt to the exporter. The operation and risks involved in different methods of payment are discussed extensively in Chapter 3.

3.2.2 Independent guarantees

The second alternative for the exporter in his quest to make sure that he will get his money is to involve third party guarantees issued by a bank, insurance company or other third party. The usual bank guarantee employed in the course of international trade has the form of a primary and independent undertaking by the guarantor to pay the exporter (or generally the beneficiary) if the conditions laid down in the guarantee itself are satisfied accordingly. The availability of the actual funds from the guarantor can be subject to various conditions detailed in the agreement of guarantee or alternatively the funds may be available 'on demand'. In the case of the latter the guarantor must pay on first demand by the beneficiary and in the former, the obligation of the guarantor is normally activated by the production of a certain document proving that the money is due to be paid to the beneficiary or that the other party is in default. The documents required are subject to the agreement between the parties involved and can range from a judgement or a award in favour of the beneficiary to a certificate of a neutral person or even a mere statement of the beneficiary.²³

The primary, independent guarantees discussed above provide that the payment obligation of the guarantor is subject only to the conditions of the guarantee itself. In this respect these guarantees are similar to letters of credit issued by banks. This is due to the fact that the undertaking of the third party is in both cases independent from the underlying contract on which the buyers obligation to perform is based.

²³ Schmitthoff, 446-452.

The 'classic' forms of guarantees are distinctively different to the independent types of guarantees. Here, instead of having the obligation to pay only if the requirements of the guarantee are fulfilled, the guarantor undertakes to be liable to the creditor if the principal debtor fails to discharge his obligation to him. This is a secondary obligation subsidiary to the contract between the creditor and the principal debtor.²⁴

According to Schmitthoff, both types of guarantees mentioned above are used in international trade, although the form of primary and independent guarantees more often. For the exporter the aim of using guarantees is clear; to ensure payment of the purchase price by either substituting a 'reliable paymaster' for the buyer²⁵ or, by having a guarantor to 'back up' the buyer in case he should default.²⁶

A special type of guarantee is the so called 'parent company guarantee' or letter of comfort, in which a parent company promises to keep their subsidiary capitalized in order for it to be able to comply with its contractual obligations. A letter of comfort is not independent from the underlying agreement and although, in case of international sales, it offers some protection against buyer's bankruptcy, its ability to protect against the guaranteed subsidiary's unwillingness to pay in case they claim some sort of breach of contract, is non-existent.²⁷

3.2.3 Insurance, factoring and forfeiting.

Insurances against non-performance of the customer and against most other commercial risks are available both privately from insurance companies and in most countries also from governmentally operated, export supporting entities.²⁸ Insurance, though, is not a method of securing the payment from the customer overseas. It is rather a back-up device in case other

²⁴ Schmitthoff, 446-452.

²⁵ This method is conceptually very similar to a letter of credit operation. The only difference seems to be that the beneficiary is able to demand payment alternatively from the guarantor or the buyer, whereas under letter of credit payment can only be demanded from the bank and only if it fails, from the buyer himself.

²⁶ Schmitthoff, 446-452.

²⁷ Schiller, lectures.

²⁸ Schmitthoff, 471-487.

possible methods of risk management fail. It may also be the case that in a very competitive market situation an exporting company will find it easier to do business with less secure, less costly and easily marketable payment terms coupled with effective insurance coverage. Other forms of merchant financing such as factoring and forfeiting also play an important role to in export sales, relieving the exporter of the financial burden of the export transaction so that the exporter can concentrate on his real business, selling and marketing of his products. These instruments can resemble insurances and help the exporter to manage his payment risk and the problems of cash-flow in the course of his business.²⁹ However, the scope of this paper is to discuss exporter's payment risk management from the point of view of the various methods of payment and for this reason, these lastly mentioned financial instruments and insurances fall outside that scope and will not be discussed further.

CHAPTER 3 - PAYMENT IN FOREIGN TRADE

1. General remarks

1.1 The essential conflict in international sale of goods

As it has been mentioned earlier, paying for the goods in international sales, where the parties are in different countries, introduces a number of complicating factors that are not present in a domestic sale. In these circumstances the means of payment used by the parties become a critical aspect and the payment conditions of their contract are put into sharp focus.³⁰ The conflicting economic interests³¹ of the parties involved in an export transaction can be described shortly as follows: 'Any seller is naturally reluctant to part with control of the goods without receiving payment for them unless he can retain an interest in the goods as some sort of security for payment, and any buyer is equally reluctant to pay for goods before he has received them unless he can be given some kind of legal right over them. Neither party, moreover, wishes to have capital tied up in the goods in transit'³².

²⁹ Schmitthoff, 453-461.

³⁰ Wilde-Rafiqul Islam, 74.

³¹ Schmitthoff, 379.

³² Wilde-Rafiqul Islam, 74.

Conflicts of economic interests may not arise in practice and the parties have in that case no need to reconcile their objectives by means of any payment arrangements. This could be the situation when the parties have a longstanding relationship and/or there is little doubt about the other party's ability and motivation to comply with his contractual obligations. Even in these low-risk circumstances one of the parties might find it necessary to employ some of the more secure payment methods in order to secure himself against risks related to the environment of the other party over which he has no control.

The ordinary situation is though, that the parties are not known to each other and have little knowledge of, or trust for, the other party and the conflicting interests have to be reconciled before the parties are comfortable with binding themselves irrevocably to the particular relationship. To achieve this 'reconciliation', a interposition of a bank, or of banks, is necessary. The most frequently used payment methods in which banks are involved are a collection agreement and the documentary credit. In a collection agreement the bank receives its instructions from the seller and in the case of a documentary credit, the instructions to the bank emanate from the buyer.³³ Naturally, it is also possible that one or the other of the contracting parties is not willing to reconcile its objectives at all and insists on direct remittance of exchange as the payment method. This has the effect that one of the parties, usually the one in the weaker bargaining position³⁴, has to shoulder all risks involved in the particular transaction.

1.2 Direct remittances and documentary sales

The individual methods of effecting payment in exports can be divided into two significantly different groups; direct remittances³⁵ and documentary sales³⁶. Naturally, a documentary sale is not a method of payment in the strict sense of the word but the term is used here as the common nominator for transactions in which payment is made against documents instead of the goods. When former of the two are employed, the buyer discharges his obligation to pay by remitting

³³ Schmitthoff, 379.

³⁴ Goode, 640.

³⁵ Term is used by Hugo and refers 'collectively to the payment methods "cash in advance" and "open account".'

³⁶ Motala, lectures.

the funds directly to the seller when the agreed due date arrives. Services of banks are used frequently in these remittances but the role of the bank is not to help the parties to secure the transaction in contradistinction to documentary sales. Here the difference between direct remittances and documentary sales is clearly to be seen. In documentary sales, meaning documentary collections and documentary credit operations, the buyer actually pays against the commercial documents representing the goods and the possession of these documents then, gives the buyer a right to collect the goods on discharge. This arrangement is the heart of the more secure methods of payment since it enables the transfer of ownership to coincide with the payment. Naturally, this observation is subject to the fact that one of the documents discussed has a character of a so called document of title which enables the ownership to be transferred with the tender of the documents. The most common document of title used in export transactions is the bill of lading.³⁷

2. Direct payments from buyer to seller

2.1 Payment in advance

For the exporter, a full payment of the purchase price in advance is the most secure of the various methods of payment and an exporter, who is able to sell on these terms, reduces the financial risk of the export transaction to a minimum.³⁸ The seller will have simultaneous control of both funds and goods and the buyer is forced to obtain the exchange in advance of receipt of the merchandise and to trust his seller's prospective performance.³⁹ However, a downside to the advance payment terms is that they are typically not very competitive and the seller may not be in a position to insist on them due to the fact that buyers usually prefer suppliers who will meet their reasonable credit needs.⁴⁰ Exceptions to this general rule of international business are exporters who, based upon past experiences and high demand for their product, insist constantly upon payment in advance in their sales contracts and are able to get

³⁷ Yiannipoulos, 4-6.

³⁸ Schmitthoff, 380.

³⁹ Kozolchyk, 5.

⁴⁰ Berman-Kaufman, 243.

it.⁴¹ Even if this is the exception rather than the rule, getting paid before committing himself irrevocably to anything, is the most desirable option for the exporter in terms of his exposure to credit risks.

If the exporter is in the position to have a payment in advance- provision included into the contract of sale, there are still a few factors to be considered. The actual payment of the price may be effected either by direct payment made by a banker at the buyer's instruction, to the seller or, by use of a bill of exchange drawn by the seller on the buyer.

2.1.1 Direct payments

Direct payments can be effected in the form of a transfer of funds or by means of a bankers draft.⁴² A transfer of funds can be effected by a mail transfer, telecommunicated transfer or a SWIFT⁴³ transfer. In these cases, the buyer's bank remits the price to his correspondent in the seller's locality and the correspondent notifies the seller and pays the amount to the seller or to the credit of his banking account.⁴⁴ Alternatively, in cases where banker's drafts are employed, an order to pay the seller is addressed to a bank in sellers country. The draft is issued by the buyer's bank.⁴⁵

Using these forms of direct payment, the seller has the opportunity to demand payment in 'cash with order' , 'cash on delivery' or some other format defining the time when payment should be effected. The ideal term for avoiding all possible credit risks is obviously 'cash with order'. The latter of the two, 'cash on delivery', is particularly suitable for the exporter when delivery is Ex Works⁴⁶ or, when transportation is arranged by land under CMR⁴⁷. If the goods are sent on 'cash

⁴¹ Comerica Incorporated.

⁴² Benjamin's Sale of Goods, 1375-1376.

⁴³ Society for Worldwide Interbank Financial Telecommunications.

⁴⁴ Benjamin's Sale of Goods, 1377.

⁴⁵ Wilde-Rafiqul Islam, 75.

⁴⁶ ICC Incoterms: 'Ex Works' means that the seller fulfils his obligation to deliver when he has made the goods available at his premises (ie. works, factory, warehouse, etc.) to the buyer.

⁴⁷ Convention on the Contracts for the International Carriage of Goods by Road.

on delivery'- terms under CMR and the carrier relinquishes control of them to the buyer without insisting on payment in cash, the carrier will be liable for compensation.⁴⁸ Also, according to Edwards, 'cash on delivery' is useful when small-value goods are exported via post and through the postal service of the foreign country and the goods are only released to the buyer against payment of the invoiced amount.⁴⁹ The latter, due to the fact that the goods will be shipped before payment has been received, is already a compromised version of an advance payment and therefore only semi-secure.

Apart from the situation where the exporter faces a production risk⁵⁰ or expense, both cash terms mentioned before are very secure and the payment risk is minimal. If however, the exporter has to run a production risk or expense, this should be reflected in the agreed payment terms and payment should be received before manufacturing of the goods begins. If the product is standard, it is slightly more helpful for the customer and no more risky to the exporter to use less strict terms, for example 'cash before shipment'.

The downsides of a full advance payment arrangement are few. It must be noted though in this context that some countries expressly forbid imports on 'cash in advance'- terms.⁵¹ Also, a direct transfer of funds involves the risk of a fluctuation in the currency of account and the parties will have to take extra measures to deal with the exchange risk. By paying by means of a banker's draft the parties run the risk 'that the document itself may be lost during transit and if it falls into the hands of an unscrupulous person who forges the payee's indorsement, presents the draft to the drawee and obtains payment, the question arises as to which of the innocent persons involved must bear the loss.'⁵²

⁴⁸ CMR, Art. 21.

⁴⁹ Edwards, 111.

⁵⁰ A situation, where the seller has agreed to manufacture or acquire a specialized product that can not be resold at the marketplace due to its specialized nature.

⁵¹ Edwards, 111.

⁵² Benjamin's Sale of Goods, 1377-1382.

2.1.2 Bills of exchange

The common situation in exporting is though, according to Schmitthoff, that the buyer is not willing to simply remit the purchase price to the seller, but would rather allow him to draw a bill of exchange on him. A bill of exchange is a unconditional order requiring payment of a prescribed sum of money at a fixed future time. The payment will be made to the bearer of the bill of exchange or to the order of a specified person. The order to pay emanates from the exporter, the drawer, and is addressed to the buyer, the drawee. The bill of exchange is send to the drawee for acceptance and it is effected by expressly confirming in writing on the bill, that the obligation to pay described in it will be honoured. The order is usually given to a third party but can also be given to the drawer in which case the bill of exchange actually is a promissory note.⁵³ The bill of exchange arrangement allows the buyer a definite time of credit unless the bill of exchange is payable at sight. The use of bill of exchange does not necessarily put the seller in a disadvantaged position in terms of his cash flow due to the fact that he is able to obtain a negotiable instrument which he can, subject to buyer's financial standing, turn into cash in the money market at once.⁵⁴ This is done by discounting the bill of exchange. When a bill of exchange is discounted , the holder of the bill obtains the value of the bill, reduced by the amount of the discount, before the bill is due. The extent of the discount will depend on the creditworthiness of the buyer.⁵⁵

The bill of exchange will require the buyer to accept the bill drawn and sent by the seller. The seller then presents the bill for payment. From the exporter's point of view there are two factors that he is concerned of. First of all, there is a possibility that the buyer fails to accept the bill of exchange when it is sent to him and secondly, the risk that the bill will be dishonoured when it falls due.

Discussing the exporter's payment risk in situations where the parties to the contract have agreed on a payment in advance clause, a risk that the buyer will not accept the bill of exchange sent to him exists, but is of limited importance and cannot, in the strict sense of the word, be

⁵³ Van Houtte, 334.

⁵⁴ Schmitthoff, 381.

⁵⁵ Wilde-Rafiqul Islam, 75.

called a payment risk. This is due to the fact that the seller has no contractual duty to perform before he has received prompt payment or before the bill of exchange drawn by him is accepted by the buyer. The seller is able to retain physical possession of the goods and he can either demand the contractually prescribed performance and/or damages from the buyer or, if the breach by the buyer is considered serious enough, terminate the contract. The termination of the contract in this situation is available as a remedy only if it is considered that the default of the buyer attains a certain minimum degree of seriousness. This principle exists in one form or the other in most legal systems.⁵⁶

The risk that the accepted bill of exchange is eventually dishonoured has a more important role in the context of advance payments. Here the acceptance of the bill usually has, unless it is payable at sight, the effect that the goods are dispatched to the buyer and thus, the seller loses physical possession over them before he actually is able to obtain payment. In this situation, the seller puts his trust to the legal nature of the bill of exchange knowing, that if the bill is dishonoured, a summary judgement against the buyer, based on the accepted bill of exchange, is available to him. In other words, the seller relinquishes control of the goods in exchange for a claim based on a liquid document and, as Hugo states, a claim based on a liquid document is easier to enforce than a claim based on the contract of sale itself.⁵⁷ The bill of exchange is independent from the underlying contract of sale and it is clear that in certain cases the seller is able to enforce buyer's acceptance, although the buyer might have a good defence to an action under the contract of sale. Even if the goods are in such defective condition, as to justify their rejection, the buyer has a defence to an action for the price but, may nevertheless be liable on his acceptance.⁵⁸

Important from the point of view of the exporter is the possibility of acquiring an aval or guarantee to secure the drawee's performance under a bill of exchange. The giver of an aval is bound in the same way as a person for whom the aval is given. The liability created under an aval is not accessory and the giver remains liable even if the guaranteed undertaking is null and void. In the common law system, in contradistinction to the Geneva system on which the aval is

⁵⁶ Treitel, 126.

⁵⁷ Hugo, 4.

⁵⁸ Benjamin's Sale of Goods, 1407.

based on, the guarantees relating to negotiable instruments are based on the general principles of suretyship. This has the effect that the guarantor of a negotiable instrument may raise any defences against the normal holder drawn from the law of suretyship.⁵⁹

2.1.3 Diversity of rules relating to negotiable instruments

The risks that the exporter faces when employing bills of exchange as the means of effecting payment are not easily defined due to diversity of the governing rules and that in itself is a risk factor to be considered. The laws governing bills of exchange and promissory notes are naturally not the same in different countries. Furthermore, in the case of these negotiable instruments, two major systems of rules co-exist along the lines of civil law and common law systems. This diversity is causing many inconveniences 'in a matter in which formalities are highly important as they govern the validity of the instrument and its legal effects.'⁶⁰ The civil law approach to the subject is based on the local implementation of the Uniform Law relating to Bills of Exchange and Promissory Notes⁶¹ and the common law countries have adopted a system, which goes back to the English Bills of Exchange Act 1882 and to the United States Uniform Negotiable Instruments Act 1892. According to Van Houtte, these systems contain divergent substantive rules on some essential issues and, moreover, the interpretation by the national courts of the said 'uniform' rules is sometimes inconsistent.⁶² Also important to mention is that some countries have adopted the Geneva Convention for Settlement of Certain Conflicts of Laws in Connection with Bills of Exchange and Promissory Notes. This convention contains more flexible conflict of law rules for disputes arising from the use of negotiable instruments.⁶³

Different legal systems relating to negotiable instruments give rise to many difficulties and for this reason the United Nations Commission on International Trade Law (UNCITRAL) tries to provide the business community with rules that would unify the divergent rules relating to

⁵⁹ Van Houtte, 339.

⁶⁰ Ibid., 336.

⁶¹ Geneva Convention providing a Uniform Law for Bills of Exchange and Promissory Notes, June 7, 1930.

⁶² Van Houtte, 336.

⁶³ Ibid., 337.

essential aspects of international trade. From the point of view of negotiable instruments the result of this aspiration is a 'compromise' between the common law system and the Geneva system; the United Nations Convention on International Bills of Exchange and International Promissory Notes⁶⁴. The convention does not seek to replace the existing systems, but instead, provides an alternative regime available only in respect of certain international instruments. According to the Convention, it only applies to an 'international bill of exchange' if it includes the heading 'International Bill of Exchange (UNCITRAL Convention)'.⁶⁵ The Convention only applies to international negotiable instruments. Therefore an instrument is subject to the convention if that instrument is expected to circulate between at least two nations, one of which has to be a contracting state. The Convention is optional in nature and the parties are free to choose it as the governing law for their international instruments.⁶⁶

In order to define some of the risks the exporter is exposed to in a bill of exchange operation, a comparison of the important aspects between the major systems and the UNCITRAL Convention is necessary. Important factors for the exporter to know are the claims and defences the buyer can make when trying to avoid payment under a bill of exchange. Under the Geneva system, the lawful holder of the negotiable instrument is in principle protected against rights and defences which the debtor-buyer invokes on the basis of the underlying agreement. In comparison, under the common law system, a normal holder, in contradistinction to a holder in due course, is open to a variety of defences and claims and thus, is less protected than the lawful holder under the Geneva system. A common law holder in due course is a holder without knowledge of any claim to, or defence upon, the instrument by the debtor (buyer), or by third person, and therefore has special protection.⁶⁷

The UNCITRAL compromise between the two is a set of rules which distinguishes between a 'protected holder' and a 'normal holder'. Under the Article 32 of the Convention every holder is presumed to be a protected holder unless the contrary is proved. A holder is called a

⁶⁴ Convention on International Bills of Exchange and International Promissory Notes. Approved and opened for signature by the General Assembly of UN on December 9 1988.

⁶⁵ Benjamin's Sale of Goods, 1390.

⁶⁶ Van Houtte, 337.

⁶⁷ Ibid., 338-339.

protected holder when he was without knowledge of a defence upon or claim to the instrument, and who was bona fide when the instrument was obtained.⁶⁸ A party may not set up a defence against a protected holder unless specified defences under certain circumstances defined in the Convention are available to him.⁶⁹ A normal holder is in a weaker position for the reason that, in addition to these defences which can be set up against a protected holder, he can also be confronted with defences based on the underlying agreement. This possibility is limited to situations where the holder took the instrument with knowledge of such defence or if he obtained the instrument by fraud or theft.⁷⁰

Resulting from the comparison, the following can be concluded. A protected holder under the Convention seems to be better protected than a holder in due course under the common law system but, less protected than a lawful holder under the Geneva system.⁷¹

2.2 Open account

Open account payments are clearly on the opposite side of the spectrum of sales to the advance payments in terms of the exporter's payment risk. The exporter will send the goods and commercial documents, possibly accompanied with financial documents, to the buyer who is invited to settle the debt on a previously agreed date. The buyer has the possibility to control and inspect the goods before payment falls due and in case the goods do not confirm with the agreement, the buyer is most likely to refuse payment.⁷² Obviously the exporter has to face the credit risk of an insolvent or dishonest buyer refusing to honour his obligation in a foreign country, and the additional risk of an interim devaluation of the currency of payment.⁷³ The possibilities of effecting the actual payment of the price have already been dealt with in the previous part (2.1) and will not be repeated here.

⁶⁸ Art. 29.

⁶⁹ Art. 30.

⁷⁰ Art. 28.

⁷¹ Van Houtte, 338.

⁷² Ibid., 341.

⁷³ Kozolchyk, 5.

Despite the fact that most writers and bankers have labelled open account terms 'for trusted customers only',⁷⁴ Hoyle has pointed out that some 40 per cent of world sales are made and paid in this manner.⁷⁵ As one bank advises its customers: 'In an open account transactions, the buyer generally receives the goods followed by the invoice and related shipping documents and then makes payment. Both parties should be familiar with one another when using this form of exchange since the terms of payment are based primarily on trust. The buyer doesn't take any risks since he has both the goods and the funds at the same time. If the buyer reneges on the contract or refuses or delays payment, the seller may have to take legal action. Therefore, when substantial sales are involved, or when parties are unfamiliar with one another, we advise tighter controls.'⁷⁶

Although the risks to the exporter are obvious, open account payments are suitable for some transactions and have significant economic advantages in cases where the exporter has no doubts about the solvency and willingness of his debtor to pay. First of all, open account terms can be used when parties have a longstanding and trustful business relationship or when the parties are legally related. In these situations open account payments are commonly used in the way that the seller forwards invoices to the buyer for specified shipments, and the buyer settles the account periodically by direct payment.⁷⁷ Secondly, if the parties to the sales agreement are situated in countries which have regular dealings with each other and have similar legal systems, thus making it possible to take legal or other action in the buyer's country without too many complications, it may be economically desirable for the exporter to use open account terms in these circumstances of reduced risk. In this context Van Houtte mentions the example of the countries of the European Union.⁷⁸ Another possibility for the exporter is to use open account terms for small orders from existing customers to begin to build trust in the relationship in order to progress into full open account relationship later on.⁷⁹

⁷⁴ see Wilde-Rafiqul Islam, 76; Kozolchyk, 5; Van Houtte, 341; Edwards, 119; Todd, 6-9; Hedley, 201.

⁷⁵ Wilde-Rafiqul Islam, 76. Original text by Hoyle was not available to me.

⁷⁶ Comerica Incorporated.

⁷⁷ Wilde-Rafiqul Islam, 76.

⁷⁸ Van Houtte, 341.

⁷⁹ The Institute of Management and Administration, MICC Survey.

As said, the risks of selling on open account terms are imminent and a company involved in export trade should be careful in using this particular method unless suitable circumstances, some of which are mentioned above, exist. However, from an economic or sales efficiency point of view, it is a known and well researched fact that loose credit terms increase sales and have a positive effect on the market share of the exporting company. Therefore it is essential that a balance is struck between 'loose' payment terms which may lead to realization of payment risks and 'strict' terms which on their side may have the effect of preventing sales. Also, it may be difficult to a company to insist on anything else than open account if these terms are regularly offered by the existing competition in that particular market or if, as is the case in certain parts of the world, the credit terms are a matter of pride and a company may be offending the customer by asking for any of the 'secure' methods of payment.⁸⁰ Obviously in these circumstances the exporting company has only a few choices. The safe option is to withdraw from the particular sales operation and the other possibility is to offer the customer loose credit terms and then secure the transaction by other means such as credit insurance, factoring etc.

As a short conclusion on direct payments from the buyer to the seller it can be said that these terms, payment in advance and open account, should be employed in an export transaction whenever it is possible and the sensible thing to do. If the exporter is able to keep his sales figures on a satisfactory level, due to a high demand for his products etc, when using payment in advance terms, he should be encouraged to use these terms. This particular method offers unbeatable payment security for the exporter. On the other hand, if the exporter is able to sell 'open account' without being exposed to an unacceptable degree of risk, arising from whatever source, it is the most desirable method of payment due to its commercial advantages and attractivity to buyers in sales operations. The 'possibility' of using these methods does not mean that they should be used in all possible cases, but it rather means that these methods of payment are uncomplicated and inexpensive to use and if they produce the desired objectives, ie prompt payment, there is no reason for the exporter to employ complicated, expensive and perhaps time consuming methods.

⁸⁰ The Institute of Management and Administration, MICC Survey.

Due to the fact that selling on open account terms is easier than selling on more secure payment terms, the exporter can always consider combining different methods. In the context of direct payments the two methods can work effectively together when combined. If the exporter is able to offer open account terms on part of an order, with cash in advance on the other part, the advantages of these two methods will be partly available. The buyer gets comparatively loose credit terms and exporters open account risk is reduced by the amount of the advance payment.

3. Documentary collections

3.1 Operation generally

In documentary collections, payment is obtained through the banking system by the exporter passing the appropriate documents, plus possibly the bill of exchange, to his bank with instructions to collect the funds on his behalf.⁸¹ The exporter maintains control over the merchandise shipped, while the exporter's bank sends the documents (eg. commercial invoices, packing lists and bills of lading) to the importer's bank for presentation and payment. Upon receipt, the importer's bank will notify the importer that they are holding these documents pending payment and/or acceptance. After payment (or acceptance to pay at some future date as agreed) is made, the importer's bank releases the shipping and title documents to the importer, and funds are remitted to the exporter's bank for payment to the exporter. Here the importer's bank and the exporter's bank act as intermediaries for the parties involved without accepting the credit risk or undertaking any obligation to pay.⁸²

By using the documentary collection methods, the exporter protects himself by retaining effective control of the goods until payment is made to him. However, the exporter still faces the commercial risk ie. the risk that the buyer is unable or unwilling to pay.⁸³ Also an unwanted event for the seller would be the cancellation of the order by the buyer after the goods have been dispatched. The exporter's protection against cancellation of the order is based solely on the contractually agreed consequences of a breach and documentary collection, as a method of

⁸¹ Edwards, 144.

⁸² Comerica Incorporated.

⁸³ Hugo, 4.

payment, offers no protection in this particular case.⁸⁴ Both of these risks can, if realised, leave the exporter in the difficult situation of having to dispense of the goods in a foreign port on what may well be a falling market.⁸⁵ Furthermore, the buyer's country may introduce stricter exchange controls and the seller might be unable to obtain payment even if the buyer is willing to settle his debt.⁸⁶

3.2 Operation under Uniform Rules for Collections

Before the mechanics and risks involved in documentary collection arrangements are discussed further, it must be pointed out that the documentary collections are, as a general rule, governed by the Uniform Rules for Collections published in 1956, and last revised 1978⁸⁷, by the International Chamber of Commerce (ICC). Although the uniform rules do not constitute an independent source of law and they can hardly, as a whole, have the standing of trade usage,⁸⁸ they are widely followed⁸⁹ in the course of international business.

The latest revision of the Uniform Rules for Collections state that they are applicable to all collections defined in the rules and that the only case when the rules do not apply is the situation where the parties have expressly agreed otherwise.⁹⁰ It is doubtful whether the rules have actually achieved the wide application described above and Schmitthoff comments accordingly that the ICC rules are applicable only if embodied by the parties into their contract.⁹¹ This is also the opinion of Goode: 'the rules depend for their application on incorporation in to the contracts

⁸⁴ International Payment Comparison Chart by California State University.

⁸⁵ Hugo, 4-5.

⁸⁶ International Payment Comparison Chart by California State University.

⁸⁷ International Chamber of Commerce, No. 322.

⁸⁸ Benjamin's Sale of Goods, 1415.

⁸⁹ 'are usually governed by the Uniform Rules...and they are departed from in very few cases' (Benjamin's Sale of Goods, 1414-1415); 'collection arrangements are standardised by the Uniform Rules and they are widely embodied by the parties into their contracts...' (Schmitthoff, 396); 'documentary collections are governed by the Uniform Rules...' (Edwards, 144); '...their use is widespread...' (Wilde-Rafiqul Islam, 78).

⁹⁰ URC, General Provision A.

⁹¹ Schmitthoff, 396.

of the parties concerned, whether expressly or by course of dealing or usage...'.⁹² Similar approach has been taken towards the application of another important ICC publication, the Uniform Customs and Practice for Documentary Credits (UCP). Commentators have taken the standpoint that there is very little support in both the common law and the civil law countries for the notions that the UCP would apply entirely independently of the will of the parties.⁹³

However, the theoretical problems concerning the applicability of the Uniform Rules for Collections do not often translate into difficulties in practise due to the fact that a clause incorporating the uniform rules is usually included in the written agreement between the parties to a collection agreement. This is the situation in the contracts between the exporter and his bank and also in the agreements between the exporter's bank and the importer's bank. Questions have arisen about the applicability of the rules to the drawee, the buyer of the underlying agreement, since generally neither a commercial nor a financial document incorporate the rules and they are most unlikely to be included in the underlying agreement.⁹⁴

According to the General Provision B of the uniform rules, a collection means the handling by banks, on instructions received, of documents in order to (a) obtain acceptance or payment, or (b) to deliver commercial documents against acceptance or payment, or (c) to deliver documents on other terms and conditions. Documents are divided in to two classes. 'Financial documents' means bills of exchange, promissory notes, cheques, payment receipts or other similar instruments used for obtaining the payment of money.⁹⁵ 'Commercial documents' means invoices, shipping documents, documents of title or other similar documents or any other documents whatsoever, not being financial documents.⁹⁶ Under this provision a documentary collection has the meaning of a collection of financial documents accompanied by commercial documents of the collection of commercial documents only. A collection of financial documents not accompanied by financial documents is called a clean collection.⁹⁷

⁹² Goode, 641.

⁹³ Hugo, 164.

⁹⁴ Benjamin's Sale of Goods, 1416.

⁹⁵ General Provision B(1)(ii)(a).

⁹⁶ URC, General Provision B(1)(ii)(b).

⁹⁷ Ibid., General Provision B(1)(iii) and (1)(iv).

The Uniform Rules for Collections distinguish between two methods of documentary collections; documents against acceptance (D/A) and documents against payment (D/P).⁹⁸ The former of the two, on the other hand, has the meaning that the appropriate documents are delivered against acceptance by the buyer of a bill of exchange, payable at an agreed maturity date. The latter of the two has the meaning that the documents of title are delivered to the buyer only on actual payment in cash or by accepting a sight bill. When payment is made in cash, it is called a 'cash against documents (CAD)' collection and it is particularly useful in those countries in which a high stamp-duty is levied on bills of exchange.⁹⁹ There are also other forms of commonly used documentary collection mechanisms which the uniform rules do not mention expressly. These methods are usually variations of the two basic types mentioned above. Similar to D/A operations is a 'documents against signature of a promissory note' and it can be used, for example, when promissory notes are exempted from the stamp-duties levied on bills of exchange. If the seller wants the bill to be send back to him to be discounted he can use the 'documents against acceptance and return' or D/AR, term. Common law countries also use 'documents against acceptance and trust receipt', DA/TR, whereby the buyer holds the goods only provisionally for the account of the seller or the collecting bank.¹⁰⁰

The Uniform rules also govern a number of other events relating to documentary collections; how the collection must be realised, the presentation of the documents, the currency of payment ie. local or foreign currency, form of protest, advice to the remitting bank, charges and interests and protection of the goods in case of buyer's non-performance.¹⁰¹ These provisions will be discussed more closely in the chapter dealing with risk factors in documentary collections (3.4).

3.3 Benefits of documentary collections

The main benefit of a documentary collection is, in a clear contradistinction to open account payments, the fact that the exporter is able to remain in control of the goods until payment is made or, until he has been able to obtain a liquid document which he can use to acquire

⁹⁸ URC, Art. 10.

⁹⁹ Van Houtte, 342.

¹⁰⁰ Ibid., 342.

¹⁰¹ Articles 1-23.

payment on the money market. Subject to the credit standing of the buyer, the seller is able to discount the bill of exchange, thereby acquiring payment prior to the due date of the bill.¹⁰²

The exporter is able to make sure that the collection itself is handled according to his preferences by giving his bank specific instructions about the conditions that the buyer must fulfil before the title documents can be delivered to him. The collecting bank is only permitted to act upon these instructions given in a collection order and it must exercise reasonable care and if it does not do so, it will be liable to the exporter.¹⁰³ However, the Uniform Rules provide that the banks utilising the services of other banks (ie. collecting bank) for the purpose of giving effect to the instructions of the principal (exporter), do so for the account of and at the risk of the latter.¹⁰⁴ This has the effect that the bank in seller's jurisdiction is not liable to the exporter for possible negligence of the collecting bank in the buyer's jurisdiction. In case that the collecting bank then acts outside its competence, the exporter has to take action against that particular bank and not against the bank that is conveniently in its own jurisdiction.

The exporter will also have the important information about the fate of the collection in his use relatively quickly due to the fact that the collecting bank has an obligation to send that advice to the exporter or exporter's bank without delay.¹⁰⁵ Furthermore, in comparison to documentary credit operations, documentary collections are inexpensive and less rigid and this feature must be considered a clear advantage of the collection methods in general.

3.4 The risks involved

Under documentary collection, the intermediary banks present exporter's documents for payment, however, the banks make no commitment to pay, nor do they undertake to examine the financial capacity and credit standing of the buyer. Exporters thus maintain documentary control of the goods, but still assume the credit risk. For this reason documentary collection is considered a method significantly favouring the interest of the buyer. Kozolchyk comments that

¹⁰² Hugo, 4.

¹⁰³ URC, General Provision C and Art. 1.

¹⁰⁴ Ibid., Art. 3.

¹⁰⁵ Ibid., Art. 20.

the documentary collection methods undoubtedly eliminate some of the risks inherent in the direct remittance of exchange but in the same vain ads about the strong position of the buyer: 'By simply refusing to accept the documentary draft or instructing the bank not to pay the drafts drawn on him, buyer could exact more liberal terms from the seller. The seller would then be faced with the prospect of litigating in a foreign country without the material possession of goods that were either in transit, or, more likely, in the foreign customs house.' ¹⁰⁶ In his opinion, the documentary collection method has been a popular tool of effecting payment whenever the buyers enjoy strong bargaining power either because of individual transaction considerations or because of market conditions. ¹⁰⁷

As mentioned, the seller assumes the risk that the buyer is unable or unwilling to pay the purchase price (commercial risk) and also the risk that a change in buyer's environment makes it difficult or impossible for the seller to obtain payment (country risk)¹⁰⁸. A 'secondary' risk arising from these factors is the unenviable situation of having to litigate in a foreign country in case the 'primary' risks realize. Furthermore, a downside of a collection operation is, that the exporter has capital tied up in the goods until the collection is completed in case of D/P and when D/A is used, until the buyer honours the accepted bill of exchange. In latter case the seller, of course, has the possibility of offering the accepted bill for discount before the bill falls due.

Different variations of documentary collections include alternating degrees of risk exposure for the exporter. Obviously the D/P method is reasonably secure due to the fact that the documents relating to the goods are not released to the buyer unless payment is made, thus making it sure that the seller remains in control of the goods until the moment he receives his money. In documents against acceptance, D/A, a period of credit is allowed for the buyer and the payment is then made, when the agreed due date arrives, by honouring the accepted bill. The seller has in this instance relinquished control of the goods in exchange for a claim based on a liquid document and, although such a document is easier to enforce than a claim on the contract of

¹⁰⁶ Kozolchyk, 5-6.

¹⁰⁷ Ibid.

¹⁰⁸ The Uniform Rules for Collections (Articles 11 and 12) include a provision to protect the exporter against possible exchange control restrictions on transfers of funds.

sale itself,¹⁰⁹ the seller still has to take legal action in that particular foreign jurisdiction to either obtain payment or, regain control of the unpaid goods.

If the method of documentary collection is employed by the parties to an international sales agreement, there are some additional, payment related factors for the exporter to consider. These factors can either effect the degree of payment risk directly, or alternatively have an effect on the consequences of a non-performance of the buyer. Important questions to the exporter are, whether to protest the bill of exchange or in the case of non-acceptance or non-payment and, what to do with the rejected and/or unpaid goods in the foreign country.

According to the Uniform Rules for Collections, the collection order should give specific instructions regarding protest in the event of non-performance of the drawee. The rules also provide that in the absence of such instructions, the collecting bank has no obligation to have the documents protested.¹¹⁰ Protesting can be a effective hastener, but also has the downside of upsetting the customer relationship where genuine reason for non-payment exists.¹¹¹ A factor relating to protesting is that a formal protest by a notary public may be necessary, subject to the rules of the governing law, when matters lead to litigation. What comes to the handling of the goods in case of non-performance, the uniform rules state that the banks involved have no obligation to take any action in respect of the goods to which any documentary collection relates.¹¹² However, the exporter has the possibility to nominate a representative to act as case-of-need in the event of non-acceptance and/or non-payment and if the exporter so wishes, the collection order should clearly and fully indicate the powers of such case-of-need.¹¹³ In the case where banks take action for the protection of the goods, whether instructed or not, they will assume no liability or responsibility with regard to the fate and/or condition of the goods.¹¹⁴ The exporter should note that the goods can not be protected, in case of non-performance, by sending them directly to the address of the bank without prior agreement on the part of the bank.

¹⁰⁹ Hugo, 4.

¹¹⁰ URC, Art. 17.

¹¹¹ Edwards, 146.

¹¹² URC, Art. 19.

¹¹³ Ibid., Art. 18.

¹¹⁴ Ibid., Art. 19.

If the goods are dispatched to the bank or consigned to it for delivery without prior agreement, the bank has no obligation to take delivery and the goods will remain at the risk of the exporter.¹¹⁵

Important from the point view of exchange risk is that the Uniform Rules for Collections include provisions to safeguard the rights of an exporter by imposing the presenting banker a duty not to release the documents unless the amount paid is transferable to the exporter's country. This partly eliminates the exporter's risk of not being able to obtain payment for delivered goods due to exchange controls. This because of the fact that the uniform rules obligate the presenting banker to be aware of such restrictions and not to deliver the documents unless payment is 'immediately available for disposal in the manner specified in collection order' (local currency)¹¹⁶ or, unless payment 'can immediately be remitted in accordance with the instructions given in the collection order' (foreign currency)¹¹⁷

4. Documentary Credit

4.1 Mechanism and operation

4.1.1 Definition

'A documentary credit is in essence a banker's assurance of payment against presentment of specified documents'¹¹⁸. Documentary credit is described here by Goode in very general terms but in it's simplicity the description contains the most important feature of a documentary credit operation, namely the autonomous (excluding revocable L/C), intermediary position of a banker. A more comprehensive definition is offered by Pennington etc., who define documentary credit as: '...an undertaking by a bank to pay a sum of money to the person to whom the credit is addressed, or to accept or purchase a bill of exchange drawn or held by that person, and the undertaking is either absolute, or, more usually, is given on condition that the person fulfils the

¹¹⁵ URC, Art. 6.

¹¹⁶ Ibid., Art. 11.

¹¹⁷ Ibid., Art. 12.

¹¹⁸ Goode, 643.

requirements set out in the credit...’ The requirements of the credit could be, for example, the presentation to the bank of documents proving that the goods have been shipped by sea, land or air and will be available for collection by the bank or someone nominated by it.¹¹⁹

The banker’s assurance to pay described by Goode and Pennington etc., may take a number of different forms and this is evident, says Hugo¹²⁰, in the International Chamber of Commerce’s Uniform Customs and Practice for Documentary Credits (UCP)¹²¹:

“For the purposes of these Articles the expressions ‘Documentary Credit’ and ‘Standby Letter of Credit’ mean any arrangement, however named or described, whereby a bank (the Issuing Bank) acting at the request and on the instructions of a customer (Applicant) or on its own behalf,

(i) is to make a payment to or to the order of a third party (Beneficiary), or is to accept and pay bills of exchange (drafts) drawn by the beneficiary, or

(ii) authorises another bank to effect such payment, or to accept and pay such bills of exchange, or

(iii) authorises another bank to negotiate,

against stipulated document(s) provided that the terms and conditions of the Credit are complied with.”¹²²

This definition included in the UCP is widely accepted as well formulated. Schmitthoff describes it (Article 2, 1983 Revision) as the most comprehensive description to be found due to the fact that the UCP was first published in 1933.¹²³ Seeking an absolutely accurate definition would be pointless and as Hugo points out: ‘...a very accurate definition of a documentary credit is almost impossible due to the different varieties in use’¹²⁴ A characteristic feature of compromising, which is to be seen in most of the uniform rules given by the ICC, has also had

¹¹⁹ Pennington-Hudson-Mann, 309.

¹²⁰ Hugo, 5.

¹²¹ International Chamber of Commerce. No. 500.

¹²² UCP, Art. 2.

¹²³ Schmitthoff II, 337.

¹²⁴ Hugo, 5.

an effect on the definition of the credits in UCP and should be mentioned in this context. The Uniform Rules make an allowance for the use of bills of exchange or drafts which is peculiar to anglo-saxon countries and those influenced by their practices. The use of bills of exchange or drafts is generally a requirement in the anglo-saxon countries whereas in other countries they are not usually required, even when payment is to be effected long after shipment.¹²⁵

4.1.2 Credit in the course of business

The operation of documentary credits is based on an antecedent contract of sale between an exporter in one country and the importer in another.¹²⁶ Generally the operation employs the services of two or more banks but in the simplest case of all, only one intermediary bank is required to make a documentary credit work. In order to have a credit issued, the buyer, on whom the duty to issue the documentary credit generally lies, submits a form of application to a bank in his country. In this application the buyer then sets out in detail the terms and conditions according to which the bank is to issue the credit. The exporter then obtains payment by proving, to the issuing bank or more commonly to a correspondent bank in the exporter's country, that he has complied with the prescribed conditions set out in the credit. The evidencing of the compliance with the terms of the credit is effected with commercial documents that *ex facie* confirm with the conditions.¹²⁷

Credit clause

The export of goods involves the contract of sale as the core of the operation¹²⁸ and, as a provision of that particular contract of sale, the parties may agree that the payment is to be exchanged by means of a documentary credit. This has the effect that the buyer has the obligation to arrange for issuance of a credit which in all aspects complies with the credit clause in that underlying contract. In case the credit arranged by the buyer does not comply with the provisions of the contract of sale, the seller has the right to reject it.¹²⁹ Buyer's duty to issue

¹²⁵ Ventris, 3.

¹²⁶ Al-Suwaidi, 44. Also Goode 644; Gutteridge-Megrah, 4.

¹²⁷ Al-Suwaidi, 44-45.

¹²⁸ Goode, 545.

¹²⁹ *Ibid.*, 644.

credit is discussed more closely in 4.8. The buyer's request to the bank to issue a credit is generally done on a bank's standard form designed for this purpose.¹³⁰ It is in the interest of both of the parties that the request is detailed enough and clearly formulated. This need is also expressed in UCP, according to which instructions for the issuance of a documentary credit must be complete and precise and, that they must state precisely the documents against which payment, acceptance or negotiation is made.¹³¹ However, the issuing bank should also discourage any attempt to include excessive detail in the credit.¹³²

Issuance and advise

Once the chosen bank has approved the application for documentary credit and the credit has been issued accordingly in favour of the seller or his order,¹³³ the existence of the credit is communicated to the beneficiary of the credit. The issuing bank may inform the beneficiary directly, or alternatively it may do so through a correspondent bank which is more conveniently situated in the beneficiary's country.¹³⁴ According to Hugo it is common for the issuing bank to employ the services of a correspondent bank by requesting that bank to inform the beneficiary about the particulars of the documentary credit.¹³⁵ If the correspondent bank assumes this role, it is called the 'advising bank'. An advising bank does not engage itself into the transaction and it is only required to take reasonable care to check the apparent authenticity of the credit which it advises.¹³⁶ However, the issuing bank may request the advising bank, not only to advise the credit to the beneficiary, but also to add its own confirmation thus binding itself autonomously and definitely to the beneficiary. By accepting this undertaking the advising bank becomes a 'confirming bank'.¹³⁷

¹³⁰ Ventris, 45. Also Gutteridge-Megrah, 4.

¹³¹ UCP, Art. 5(b).

¹³² Ibid., Art. 5(a)(i)

¹³³ Hereafter referred to as 'the beneficiary' [UCP, Art. 2(i)].

¹³⁴ Goode, 645.

¹³⁵ Hugo, 7.

¹³⁶ UCP, Art. 7(a).

¹³⁷ Ibid., Articles 9(b) and 9(c).

Presentation of documents

The next step in the documentary credit operation is for the seller to dispatch the goods and present the prescribed documents to the correspondent bank in order to obtain payment. The delivery of the documents constitutes a constructed delivery of the goods and therefore, since the deliverer cannot inspect the goods themselves, the documents will be inspected with great care. The presentation of the documents is called evidencing due to the fact that they prove that the merchandise required has been shipped and dispatched, and that they purport to be of the type, quantity and quality ordered.¹³⁸ The beneficiary, in order to obtain payment, must be able to show that he has completed his side of the bargain and this can only be done by presenting exactly those documents that the credit stipulates for.

The documents to be presented to the bank under the credit are usually a) a commercial invoice, consisting of the name of the buyer, description of the goods and purchase price, b) a insurance document proving that the goods have been insured against damage during transit and c) transport documents showing that the goods are in the hands of a carrier for transportation to the buyer.¹³⁹ The documents which the buyer wishes to see as a condition of his bank making payment are, of course, entirely for the parties to decide and for this reason, in addition to the documents described above, various other documents such as certificate of origin, certificates of quality and inspection, certificates of weight and quantity, consular certificate etc. may be required from the beneficiary.¹⁴⁰

If the documents tendered by the beneficiary appear on their face to be in compliance with the terms and conditions of the documentary credit, the corresponding bank will pay, accept or negotiate the drafts.¹⁴¹ If, however, the documents do not confirm with the credit and cannot be amended and represented before the expiry date of the credit, it is for the applicant (buyer) to decide whether or not to authorise payment against non-complying documents.¹⁴² It may be the

¹³⁸ Al-Suwaidi, 49.

¹³⁹ Hedley, 219-220.

¹⁴⁰ Gutteridge-Megrah, 5; Hedley 223-225.

¹⁴¹ UCP, Art. 13(a).

¹⁴² Al-Suwaidi, 49.

case that a bank will for some reason pay against documents that have discrepancies in them. This has the effect that the bank itself bears the risk of the transaction.

Bank to bank reimbursement

After the beneficiary of the credit has received payment, the correspondent bank delivers the documents relating to the goods to the issuing bank. This will again be done only once the correspondent bank has been reimbursed itself. If the correspondent has accepted faulty documents from the beneficiary, it now faces the possibility that the issuing bank will not take up the documents due to the discrepancies. The risk is imminent because the issuing bank itself knows that it will not be reimbursed by the buyer if the documents do not comply.

Delivery to buyer

However, assuming that the documents comply and they are accepted by the issuing bank, the buyer will get the documents from the issuing bank against reimbursement from him and once buyer has the documents, he is able to take delivery of the goods on dispatch. During the whole operation the parties involved have been dealing with documents only and not with the goods to which the documents relate. This is one of the basic elements of a documentary credit transaction¹⁴³ and for this reason the buyer can make absolutely sure that he has received what he contracted for only when he takes delivery of the goods.

4.1.3 Functions of a documentary credit

A documentary credit offers a method of managing the risks inherent in foreign trade and once employed, it includes mutual benefits to the contracting parties. The first and foremost function of a documentary credit operation is to secure the transaction in such a way that both the exporter and the buyer can have confidence that the contractually agreed obligations will be fulfilled by the other party. The security function of the credit has also given reason for the description 'Kind des Misstrauens' - child of mistrust in the German literature.¹⁴⁴ Security being

¹⁴³ UCP, Article 4.

¹⁴⁴ Ulrich, 13.

the most important of the functions of a documentary credit, it also has other important roles in multinational transactions namely the payment function and sometimes a credit function.¹⁴⁵

4.1.3.1 Security

The issuing of a documentary credit diminishes the credit risk of the exporter dramatically. Instead of having a claim against the buyer in a particular foreign country the exporter now has an independent claim against a bank which usually is far more able and secure as a debtor. This feature of security is created by the principle of independence of a documentary credit. Article 3 of the Uniform Customs for documentary credits expressly states that credits by their nature are separate transactions from the sales or other contracts on which they may be based.¹⁴⁶ Due to this fact the relationship created between the beneficiary and the issuing bank is also often described as abstract. The operation as a whole creates a situation where the payment will most likely be made to the exporter if he himself is able to fulfill his contractual obligations, a fact that he has to prove by presenting a set of complying documents to the bank.

From the point of view of the buyer a documentary credit also has its benefits. Since the buyer is generally not able to inspect the goods himself, he has to rely on documentary proof that the goods he has contracted for in fact are what they are purported to be. In order to do this, the buyer has the right to 'choose'¹⁴⁷ the documents, against which payment can be made. In the form of his instructions to the issuing bank, the buyer is able to select any documents which in his opinion prove that the other party has fulfilled his contractual obligations. At least in theory this has the effect that the buyer has, through his bank, complete control over the conditions of the actual payment. This protection is however absolute only in theory due to the fact that payment to the seller is always made against documents and not against the goods themselves¹⁴⁸. It is then possible that buyer's bank quite rightly releases payment and the buyer still can end up with rubbish and litigation in the unfortunate case where the seller is able to acquire complying documents against non-complying merchandise.

¹⁴⁵ Hugo, 18. Also Ulrich 22-26.

¹⁴⁶ Art. 3.

¹⁴⁷ It is submitted that the 'choice' is subject to the approval of the seller.

¹⁴⁸ UCP, Art. 4.

4.1.3.2 Payment

As explained earlier, the parties may agree that the payment shall be made in the form of a documentary credit. This agreement, the credit clause, forms a part of the underlying agreement between the parties. The credit clause creates an obligation to the buyer to arrange for the opening of a documentary credit. In other words the buyer is required to pay by means of a documentary credit¹⁴⁹ and a failure to do so will be understood as a breach of contract. The opening of the credit does not, according to the general opinion,¹⁵⁰ amount to a absolute payment and for this reason the obligation to pay under the underlying contract is merely suspended and not discharged. Therefore if payment is for some reason not made by the bank the buyer may still be liable under the contract of sale.¹⁵¹

4.1.3.3 Credit

Documentary credits are not credit instruments as such although they may have this feature if arrangements to that effect are made. It is possible that the issuing bank is not willing to be bound to an irrevocable obligation to pay to the exporter unless the buyer secures the interest of the bank by depositing that particular amount of money to that bank. In cases where this kind of security is required from the applicant of the credit, the documentary credit does not have a credit function. According to Hugo: '...the credit function arises only insofar as the bank is willing to issue the credit prior to receiving the money from its client. The bank can thereby enable the buyer to finance the import out of the sale of the goods he has imported'¹⁵².

4.2 Uniform Customs and Practise for Documentary Credits

The UCP sponsored by the International Chamber of Commerce has been almost universally adopted and it has brought about a high degree of uniformity to the law relating to documentary credits. The UCP reflects existing practise and lays down the rules for inter alia the form of

¹⁴⁹ Hugo, 18.

¹⁵⁰ Ellinger, 532.

¹⁵¹ Hugo, 18.

¹⁵² Ibid., 18.

documentary credits, the requirements for the issuing and for the further stages of the credit, the obligations and liabilities of the banks etc.¹⁵³ For this reason it is impossible to write about documentary credits without commenting the rules and principles set out in the UCP. Naturally in this context an important question is the legal nature and applicability of the UCP. The current 1993 revision of UCP provides that its provisions '... shall apply to all Documentary Credits where they are incorporated into the text of the credit'. In Hugo's opinion this means that the drafters of the UCP treat its application as being based primarily on express contractual incorporation.¹⁵⁴

In his thesis Hugo also writes: 'The majority of commentators favour the view that the UCP, to be applicable, must be incorporated by the parties into their contract. There is very little support in both the civil-law and common-law countries for the notion that the UCP may apply in its entirety independently of the will of the parties. However, certain commentators from the European continent have argued that certain provisions of the UCP may well apply independently of the will of the parties. Such provisions are then regarded as having been incorporated into the contracts by operation of law'.¹⁵⁵

Although widely debated by academics, in practise there are very few disputes over the legal nature of the UCP due to the fact that the UCP is in most cases explicitly incorporated into the contract and the documentary credit themselves.

4.3 Autonomy and strict compliance

There are two fundamental principles that give the documentary credit those qualities that make it as useful as a payment method as it is. These are the doctrines of autonomy, or independence, and of strict compliance. One of the primary functions of a documentary credit is to create an abstract payment obligation independent of and detached from the underlying contract of sale between the seller and the buyer and from the separate contract between the buyer and the

¹⁵³ Van Houtte, 266.

¹⁵⁴ Hugo, 146.

¹⁵⁵ Ibid.

issuing bank.¹⁵⁶ Goode describes it as the cardinal rule of documentary credits: '...the conditions of the bank's duty to pay are to be found exclusively in the terms of the credit and that the right and duty to make payment do not in any way depend on performance by the seller of his obligations under the contract of sale'.¹⁵⁷ Autonomy of the credit is also spelled out clearly in the UCP as it provides that 'Credits, by their nature, are separate transactions from the sales or other contract(s) on which they may be based and banks are in no way concerned with or bound by such contract(s).'¹⁵⁸

Autonomy is given to a credit in order to avoid a situation where a bank might be drawn into a dispute between the buyer and the seller or to use its knowledge of the sale transaction, for example, to exercise some form of discretion in respect to compliance.¹⁵⁹ The doctrine of strict compliance on the other hand, although closely related to the autonomy principle, has the effect that documentary credits are only concerned with documents. UCP is quite very clear about this: 'In Credit operations all parties concerned deal with documents, and not with goods and/or other performances to which the documents may relate'.¹⁶⁰ The underlying principle is that the bank must refuse payment if the documents tendered to it do not comply strictly with the requirements stipulated in the credit. However the problem in some cases has been that courts in different jurisdictions have held divergent views as to what amounts to 'strict compliance'.¹⁶¹ Again, looking at the UCP, it states that banks are required to '...examine all documents stipulated in the Credit with reasonable care, to ascertain whether or not they appear on their face, to be in compliance with the terms and conditions of the Credit'.¹⁶² The same Article 13(a) attempts to give content to the term compliance: 'Compliance of the stipulated documents on their face with the terms and conditions of the Credit, shall be determined by international standard banking practice as reflected in these Articles. Documents which appear on their face

¹⁵⁶ Goode, 659.

¹⁵⁷ Ibid.

¹⁵⁸ Art. 3(a).

¹⁵⁹ Wilde-Rafiqul Islam, 83.

¹⁶⁰ Art. 4.

¹⁶¹ Hugo, 114.

¹⁶² Art. 13(a).

to be inconsistent with one another will be considered as not appearing on their face to be in compliance with the terms and conditions of the Credit'.¹⁶³

These provision of the UCP, which give guidelines to the banks about how they should determine whether to take up the documents or refuse them, are clearly based on the proposition that the banks are not experts in the trade concerned or are not required to have knowledge about the terms of sale. The banks therefore, are only expected to consider the accuracy of the documents presented.¹⁶⁴ The banks' position regarding documentary credit operations and the doctrine of strict compliance is well put by Viscount Sumner in a famous dictum: '...the bank's branch abroad, which knows nothing officially of the details of the transaction thus financed, cannot take it upon itself to decide what will do well enough and what will not. If it does as it is told, it is safe; if it declines to do anything else, it is safe; if it departs from the conditions laid down, it acts at its own risk'.¹⁶⁵

The doctrine of strict compliance also creates a situation which can be defined as a practical paradox. It is upheld as absolutely essential for the effective operation of credit transactions and at the same time, it is by far the principal reason why in one-half to two thirds of such transactions the tendered documents are rejected when first presented.¹⁶⁶

4.4 Risk exposure dependable upon type of credit

Before taking a closer look at the exporter's risk exposure in documentary credit operations it must be acknowledged that the majority of credits issued today in the furtherance of foreign trade have perhaps only one thing in common, they carry the promise of the issuing bank to release payment if the documents prescribed in the credit are tendered to the bank within the period of time during which the credit is available.¹⁶⁷ This means that a vast variety of credits are being used in the business world and it also means that the degree of risk exposure in a

¹⁶³ Art. 13(a).

¹⁶⁴ Wilde-Rafiqul Islam, 82.

¹⁶⁵ *Equitable Trust Co of New York V Dawson Partners* (1927) 27 LIL Rep 49.

¹⁶⁶ Buckley, 3.

¹⁶⁷ Gutteridge-Megrah, 10.

particular operation is largely dependable on the type of credit chosen by the parties. There are many classifications made of these instruments in the literature but only one is specifically recognized by the Uniform Customs and Practise for Documentary Credits, namely the classification of the credits into revocable and irrevocable ones.

4.5 Types of credits and exporter's payment risk

As mentioned above, credits may be classified in various different ways but more often than not it is done by reference to the revocability or otherwise of the bank's undertaking, the presence or absence of separate undertaking from a second bank and the time and mode of settlement.¹⁶⁸

4.5.1 Time and mode of settlement

Article 10(a) of the UCP provides that all credits must clearly indicate whether they are available by sight payment, deferred payment, acceptance or by negotiation. Clearly it is of importance to the seller to know by which means he will obtain the moneys due to him under the credit and, as the Uniform Customs stipulate, the credit itself should state which of those methods has been chosen by the parties. Furthermore, looking from the exporter's point of view, this matter should be settled beforehand in the contract under which the credit is opened.¹⁶⁹

If the parties should agree that the credit will be payable at sight, the advising bank is then instructed to pay, or arrange for payment, to the seller the moneys due to him on presentation of complying documents. The second option is to arrange for a deferred payment credit. Here the advising bank is authorized to pay, or make arrangements for payment, at some future date determinable in accordance with the terms of the credit. In case the seller requires cash before the deferred payment credit matures, it is possible for him to obtain it by negotiating the documentary credit. Of course, the negotiation of the deferred payment credit is done at a discount which reduces the amount of the credit due to the seller.¹⁷⁰

¹⁶⁸ Goode, 648.

¹⁶⁹ Schmitthoff, 421.

¹⁷⁰ Ibid., 421-422.

Instead of payment in cash the parties may agree on the third option, the acceptance credit, which means that the issuing bank will undertake to accept the beneficiary's time draft against stipulated documents.¹⁷¹ By accepting the bill, the bank signifies its commitment to pay the face value at maturity.¹⁷² The bill accepted by the advising bank provides the seller with a considerable degree of security and if the exporter does not want to hold on to the bill until it matures, he may turn it into money by discounting it or by selling it to his own bank.¹⁷³ According to Schmitthoff it is noteworthy from the exporter's point of view that 'where the issuing bank issues the credit as irrevocable, it holds itself under the UCP responsible that the bill will be accepted and paid by the buyer. Where the advising bank confirms the credit, a similar obligation is placed on it by the UCP. It follows that, even if the arrangement of the parties is that only the buyer has to accept, if the credit is made irrevocable or irrevocable and conformed and is made subject to the UCP, the seller has a considerable degree of security.'¹⁷⁴

The fourth possibility regarding means of settlement is the one where the issuing bank undertakes to negotiate rather than accept the beneficiary's time draft against delivery of the proper documents. The money acquired by the negotiation of the bill is then passed to the beneficiary. Negotiation credit enables the beneficiary to acquire payment before maturity of the bill.¹⁷⁵

The mode of settlement does not play nearly as big a role in trying to determine exporter's risks as do the undertakings of the banks involved in the particular operation, but nevertheless the mechanism of effecting payment under the documentary credit must also be closely looked at before entering into contracts. Clearly, the sight payment credit is the simplest of the options available and it could be said that it is also the safest. Looking at the other methods, acceptance and negotiation as well as the deferred payment credit generally enable the buyer to obtain the documents at a date prior to payment. The difference is merely, as Hugo points out, that whereas in the case of acceptance and negotiation credits the payment obligation is secured by a bill of

¹⁷¹ Hugo, 39.

¹⁷² ICC No. 415, 30.

¹⁷³ Schmitthoff, 422.

¹⁷⁴ *Ibid.*

¹⁷⁵ Hugo, 39.

exchange, in the case of the deferred payment it is secured by the documentary credit itself. However, using the deferred payment- method, it is possible for the parties to avoid unnecessary complexity that on the other hand is unavoidable when coupling bills of exchange with documentary credits. Also worth mentioning is that a stamp duty is often payable on bills of exchange.¹⁷⁶

From the security point of view Hugo quite rightly points out that the independence of the payment obligation and the principle of strict compliance are equally applicable to deferred payment credits and from that follows that if for instance the documents are in order but prior to the date of payment the goods are found to be defective, the buyer will nevertheless be obliged to pay.¹⁷⁷

4.5.2 Banks' undertakings

For the exporter, the most important classification of credits must be the division into revocable and irrevocable documentary credits and furthermore the distinction between unconfirmed and confirmed credits. The quality of the documentary credit as revocable and irrevocable refers to the obligation of the issuing bank to the beneficiary.¹⁷⁸ Whether a documentary credit is confirmed or unconfirmed depends on the role assumed by the correspondent bank in the exporter's locality.¹⁷⁹

A revocable credit offers no security at all to the seller. Not only can the issuing bank revoke the credit at any time, but there is no obligation on the bank even to inform the seller that the credit has been revoked.¹⁸⁰ Article 8(a) of the UCP¹⁸¹ provides as follows: ' A revocable Credit may be amended or cancelled by the Issuing Bank at any moment and without prior notice to the Beneficiary'. For obvious security reasons revocable credits are not widely used and also, since

¹⁷⁶ Hugo, 39-40.

¹⁷⁷ Ibid., 40.

¹⁷⁸ Schmitthoff, 423.

¹⁷⁹ Benjamin's Sale of Goods, 1465.

¹⁸⁰ Todd, 30.

¹⁸¹ 1993 Revision, ICC No. 500.

Article 6 of the 1993 Revision provides that if a credit does not indicate whether it is revocable or irrevocable, it will be deemed irrevocable, it will no more be possible that a credit would become revocable by 'accident'. This particular rule in the Uniform Customs is a definite positive change from the UCP 400¹⁸², which deemed a credit revocable if it was not expressly stated to be irrevocable. It goes without saying that the presumption of revocability impaired the reliability of the documentary credit and had the potential to put unaware exporters in a very difficult position. The presumption of irrevocability had already been accepted in the United States and therefore, this change also has the effect of bringing the UCP in line with the Uniform Commercial Code.¹⁸³ The nature of the issuing bank's undertaking under a irrevocable credit differs greatly from a revocable credit. The essence of this undertaking is set out in the UCP: 'An irrevocable Credit constitutes a definite undertaking of the Issuing Bank, provided that the stipulated documents are presented to the Nominated Bank or to the Issuing Bank and that the terms and conditions of the Credit are complied with...' ¹⁸⁴. Furthermore the Uniform Customs provide: 'Except as otherwise provided by Article 48, an Irrevocable Credit can neither be amended nor cancelled without the agreement of the Issuing Bank, the Confirming Bank, if any, and the Beneficiary'¹⁸⁵. The beneficiary is then given the benefit of an irrevocable undertaking from the bank itself under which payment is conditional only upon presentation of the stipulated documents and compliance with the terms and conditions set out in the credit.¹⁸⁶

From the above mentioned it follows that a irrevocable documentary credit offers quite a bit more security than the 'practically worthless'- labelled revocable credit. Another writer puts it: 'The effect of an irrevocable credit is to substitute the issuing bank for the buyer as the person who undertakes to 'buy' the shipping documents and this is an undertaking which is absolute in the sense that so long as the documents of title to the goods which the seller tenders to the bank are in order, in the sense of being those prescribed in the credit, the bank must accept them

¹⁸² 1983 Revision, ICC No. 400.

¹⁸³ Moses II, 1-2.

¹⁸⁴ Art. 9(a).

¹⁸⁵ Art. 9(d)(i).

¹⁸⁶ Todd, 29.

regardless of any controversy between the seller and the buyer as to whether the contract of sale has been performed.¹⁸⁷

Irrevocable but unconfirmed documentary credits are often used by the leading banks, particularly those from the United States and Britain - banks that consider a local confirmation as unnecessary.¹⁸⁸ If however, the beneficiary is not comfortable with the undertaking of the issuing bank either because he does not know the bank or is not satisfied with the bank's creditworthiness or because he wants to localize the credit into his own jurisdiction in case litigation becomes necessary, the beneficiary should ask for a confirmed credit.¹⁸⁹ In other words, in the case of an irrevocable but unconfirmed credit, if the advising bank refuses to pay on tender of the documents, the beneficiary might be compelled to institute proceedings overseas - a situation which largely defeats the main purpose of the commercial credit.¹⁹⁰

Under a irrevocable but unconfirmed credit the correspondent banker accepts the documents tendered by the seller on behalf of the issuing banker. In this scenario the correspondent banker, ie. the advising bank, is merely acting as an agent of the issuing banker and the credit is unconfirmed on his part. If however, the exporter insists on having the documentary credit confirmed, the correspondent bank then adds its own promise to that of the issuing bank and the credit becomes a confirmed credit.¹⁹¹ This has the meaning that the conforming bank effectively takes on towards the seller all the obligations taken on by the issuing bank where the credit is unconfirmed.¹⁹² Important to note is that the obligations of the confirming bank are in addition to, and not substitution for, the obligations of the issuing bank under the credit.¹⁹³

A confirmed documentary credit clearly offers protection that is superior to that offered by the unconfirmed credit. Schmitthoff describes the advantages and usefulness of a confirmed credit

¹⁸⁷ Gutteridge-Megrah, 22.

¹⁸⁸ Schmitthoff, 425.

¹⁸⁹ Buckley, 2.

¹⁹⁰ Schmitthoff, 425-426.

¹⁹¹ Benjamin's Sale of Goods, 1467.

¹⁹² Todd, 32.

¹⁹³ Baxter, 18.

as follows: 'Confirmed credits are very popular in modern export trade because they act as a localisation device, localising the all important payment incident of an export transaction in the seller's country. If the seller has obtained the confirmation of a bank of good standing in his own country, he can be sure of obtaining payment, acceptance of his draft or it's negotiation, as arranged in the contract with his buyer, if he tenders the correct documents in good time. The export transaction is thus assimilated to a home transaction, as far as the payment incident is concerned, and the credit risk of the export transaction is practically eliminated'.¹⁹⁴ Schmitthoff also points out that confirmed documentary credits are in many trades the normal terms of settlement.¹⁹⁵

The downsides of these very secure methods of payments are that they are more complicated and more expensive than unconfirmed credits. The charge of confirmation becomes more expensive in proportion to how big the risk the bank believes it is taking in confirming the documentary credit. There are also situations where the risk may appear so high that the bank will not agree to confirm at all.¹⁹⁶ The refusal of the advising bank to confirm a credit should naturally alarm the exporter to find out more about the issuing bank and it's creditworthiness. On the other hand, as it has been pointed earlier, as long as the issuing bank is reputable, the exporter may not consider worthwhile the extra commission payable for confirmation. All these considerations add up to the conclusion that it is by no means necessary for the exporter always to demand confirmation of credits, since it may in practice add very little to his management of the payment risk as long, as the issuing bank is reputable.¹⁹⁷

4.6 The credit clause

The contract between the seller and the buyer is in the documentary credit context the contract from which all other contracts stem. The beneficiary's right to demand a documentary credit, and the nature and terms of the credit are all derived from the credit clause.¹⁹⁸ As already

¹⁹⁴ Schmitthoff, 428.

¹⁹⁵ Ibid.

¹⁹⁶ Moses, 2.

¹⁹⁷ Todd, 37.

¹⁹⁸ Hugo, 19-20.

mentioned the seller is not entitled to require, nor the buyer to offer, payment by documentary credit unless the underlying contract of sale so provides.

In Dr. Schiller's opinion, it is essential for the exporter to realise that most of what can be done to reduce his payment risk to an acceptable level, is and should be done during drafting of the underlying agreement and especially of course, when the credit clause is negotiated. Naturally, the exporter should try to have as beneficial terms as possible included into the contract, but furthermore extremely important for him is to have the most important issues agreed upon and included into the credit clause in order to obviate later disputes and uncertainty.¹⁹⁹ To do this '...the parties should set out in full the exact terms of the documentary credit to be issued. In particular the parties should agree on the following:

- 1) The type of the credit, in particular whether it should be revocable or irrevocable, confirmed or unconfirmed, transferable or non-transferable.
- 2) The currency if different from the currency of the price specified in the underlying contract.
- 3) Where the credit is to be opened, confirmed (if it is to be confirmed) and advised.
- 4) When the credit is to be opened, and what its expiry date should be.
- 5) The documents to be presented in order to obtain payment under the credit.²⁰⁰

A list of 'musts' made by Schiller is clearly along the same lines with the one just mentioned by Oelofse. However, Schiller points out that a provision should also be made for the costs incurred in the credit operation and furthermore for the rules that should govern the credit transaction.²⁰¹

4.7 Terms of the credit

It is clearly impossible to foresee all pitfalls that await the exporter in a documentary credit transaction due to the vast amount and variety of factors effecting the procedure. However, there are some guidelines that generally, when applied, will improve security of payment in documentary credit operations.

¹⁹⁹ Oelofse, 67.

²⁰⁰ Ibid.

²⁰¹ Notable is that due to the autonomy principle of documentary credits the governing law of the underlying agreement is not the law applicable to the credit itself, however it applies to the credit clause ie. its validity etc.

Type of credit

First and foremost, there is the question concerning the type of the credit. The notion that revocable credits offer no security and therefore should not be used at all is generally approved by academics and other writers throughout the world, unless of course, the seller is well aware of the implications of using this type of credit and agrees to it under special circumstances.²⁰² It follows that the credit should at least be irrevocable and furthermore the seller must insist that the buyer use a bank well-known and highly regarded by the banking community. The irrevocable documentary credit serves no purpose if the issuing bank, assuming the risk of the buyer's insolvency, is itself financially weak. On the other hand, if the issuing bank is a world-class bank, it may well be that an irrevocable credit offers the seller all the security needed in a more cost effective manner than a confirmed credit would. Conclusion is then that if the seller does not have confidence in the bank of the buyer's choice, or if there is any question about the political stability of the foreign country where the issuing bank is located, then the credit should be, without a question, confirmed by a bank in the seller's locality.²⁰³ Of the actual methods of effecting payment under the credit the most beneficial to the exporter is clearly a credit which provides for payment at sight. Here the credit is payable immediately upon presentation of required documents.²⁰⁴

Time of opening

Another provision of the credit clause that one can comment on generally without knowing the facts of a particular contract of sale, is the time of opening of the credit. From the exporter's point of view the documentary credit should naturally be opened as soon as possible after conclusion of the contract to allow him as much time as possible to fulfil his contractual obligations. Oelofse writes: 'Ideally the credit clause should indicate exactly by which date the credit is to be opened. If the credit clause states such a date, there is no problem. However, even if no specific date for the opening of the credit is stated in the credit clause, other terms of the underlying sale may imply a certain date for the opening of the credit.'²⁰⁵ Case law on the subject

²⁰² Goode at 651 notes: '...the use of such credits may be prompted by governmental desire to police the operation of exchange control regulations'.

²⁰³ Moses, 2.

²⁰⁴ Schiller, lectures.

²⁰⁵ Oelofse, 73.

clearly spells out the requirement for the credit to be opened at the latest by the beginning of the shipping period.

Some academic writers advice to determine the opening of the documentary credit as one of the prerequisites for the entering into force of the contract,²⁰⁶ and the possibility that the whole underlying contract of sale can be made conditional on the issuing of the documentary credit envisaged in the credit clause is also acknowledged by Oelofse. He, however takes an entirely opposite view to the usefulness of this kind of provision due to the fact that '...the buyer would then have the unilateral right to "kill" the contract of sale by simply refusing to have a letter of credit issued. The seller would have no cause for complaint or legal remedy since no enforceable contract has come into being.'²⁰⁷ In his comment Oelofse also suggests that the "normal" situation would be one where the issuance of the credit is a duty undertaken by the buyer in terms of the underlying agreement, breach of which leads to the ordinary remedies for breach of contract.²⁰⁸

It is of course very difficult to determine which one of the methods discussed above will lead to the most beneficial outcome in a particular case in practise but nevertheless, it can be said that if the contract of sale be made conditional on the issuing of the credit, it offers the seller the security that if the parties ever enter into a contract, it will be only once the buyer has opened a credit that complies with the requirements of the credit clause, but it also gives the buyer an attractive possibility to follow the market in his country until the last moment before deciding on the fate of the contract.

Period of validity

When examining the different possibilities for the period of validity of the documentary credit, one has to have the prerequisite that the credit must cover all those phases of the implementation of the contract in which payment or payments out of the credit will become due. Apart from that, the expiry date of the credit should allow a large margin for error. In other words the exporter should try to make sure that the expiry date of the documentary credit

²⁰⁶ Schiller, lectures.

²⁰⁷ Oelofse, 71.

²⁰⁸ Ibid.

permits sufficient time to permit correction, if possible, of any mistakes in the documents. This is of course due to the fact that if possible discrepancies can in fact be corrected, they must be corrected and the documents resubmitted before the expiry date of the credit.²⁰⁹

The documents

The documents against which payment is to be released can, as mentioned before, be freely chosen by the parties during negotiations of the particular credit clause. However, it is especially in the buyer's interest to stipulate on the documents which in his opinion will prove that the seller has fulfilled his part of the contract. The documents normally include at least the transport documents, commercial invoices and insurance documents.²¹⁰

Considering that the non-compliance of documents with the terms of the credit creates the most frequent and the most painful kind of pitfall to the exporter,²¹¹ he should negotiate with the buyer prior to the issuance of the documentary credit exactly what documents must be presented to the bank for payment under the credit. Moses points out: '...the most important thing from the seller's point of view is to have as few documents as possible, to have as simple a description as possible, and to be sure that all documents called for by the LC can in fact be produced'.²¹² Furthermore, the basic rule to be observed by the seller is that he should agree only to such documents which he is able to procure without the co-operation of the purchaser due to the fact that the security to receive payment out of the documentary credit is diminished insofar as the procurement of the documents require co-operation from the buyer.²¹³

The Uniform Rules also make an attempt to promote preciseness and to discourage use of excessive detail in the process of employing documentary credits. Article 5(b) provides: 'All instructions for the issuance of a Credit and the Credit itself and, where applicable, all instructions for an amendment thereto and the amendment itself, must state precisely the document(s) against which payment, acceptance or negotiation is to be made. Also in the same

²⁰⁹ Moses, 3.

²¹⁰ Hugo, 8.

²¹¹ Buckley, 4.

²¹² Moses, 2.

²¹³ Schiller, lectures.

Article it is stated that '...in order to guard against confusion and misunderstanding, banks should discourage any attempt...to include excessive detail in the credit...' ²¹⁴

These are guidelines clearly directed to the banks involved in a particular credit operation and although the rules mentioned may be difficult or even impossible to enforce, they nevertheless express the concern that the drafters of the Uniform Rules had about credits which are either imprecise or excessively detailed in their stipulations. As noted, these provisions cannot be relied on and the seller should, when negotiating the sale agreement and before issuance of the credit, ensure that the credit will call for documents in precise terms ie. not vague or excessively detailed and from that most likely follows that the beneficiary will be able to obtain the documents required within the specified time limit.

Applicable rules, mode of transport, costs

As pointed out earlier, it is not entirely clear whether the Uniform Rules will apply to a documentary credit unless the applicability is stated in the credit itself. Therefore, a provision to that effect stating that the credit is subject to the prevailing version of the 'Uniform Customs and Practice for Documentary Credits' issued by the International Chamber of Commerce, is recommendable to incorporate as an element to the credit clause of the underlying contract of sale. Also, it is in the interest of the seller to be allowed to have as many options as possible what comes to the mode of transport in practical terms. ²¹⁵ Clearly, when the documentary credit allows the seller to use partshipment, transshipment and loading on deck, his possibilities to arrange for the transport of the sold goods have been extended and therefore a clause providing for the above mentioned is desirable. Schiller furthermore points out, naturally, the recommendability of a credit clause provision which stipulates to the effect that the costs of opening and of possible confirmation of the credit are to be borne by the purchaser. ²¹⁶

²¹⁴ Art. 5(a) and 5(a)(i).

²¹⁵ Assuming, as throughout this thesis, that shipping is used as the method of transport. The choice was made for the sake of convenience. See Hare at 116, where it is pointed out that 'Notwithstanding the inroads of airfreights, more than 90% of international trade is still carried as cargo by the 500 million gross tons of the world fleet of cargo-carrying merchant ships.

²¹⁶ Schiller, lectures.

Undefined terms

To crystallise the importance of a credit clause that spells out the most important issues, Oelofse raises the question of the content of the credit in the unfortunate situation where the parties have not agreed to all the details of the documentary credit to be issued. Clearly, there exists two options that a court has, should the dispute advance so far that litigation becomes necessary. Firstly the court may be willing to imply 'reasonable' or 'usual' terms into the credit or it may hold that the issued documentary credit itself can fill the contractual gap and so supplement the terms of the underlying agreement of sale. On the other hand, the court could find in the effect that the whole agreement between the parties is void due to the fact that they have not agreed on the terms of the payment.²¹⁷ However, it serves no purpose to go into detail on this particular matter since the outcome of a litigation concerning this issue will largely depend upon the jurisdiction where the dispute is litigated. As a short conclusion on this subject: 'To leave this matter (exact terms of credit) in doubt by not properly fleshing out the credit clause, is to invite unnecessary problems.'²¹⁸

Waiver by action

Again, largely dependable on the jurisdiction, but nevertheless worth pointing out is that even where the underlying agreement calls for a particular type of credit, it may be open to the seller to accept a different type providing him with less security. Furthermore, by accepting a credit providing inferior security to that provided under the contract, the seller may by his conduct be taken as having waived his right to demand the greater security at any rate without giving reasonable notice.²¹⁹ This obviously can present a risk to the seller especially in situations where numerous payments are to be made out of the same credit.

4.8 Duty to issue

Outside the realms of the documentary credit itself, the exporter faces other risks which also have to be accounted for before embarking on a particular transaction. Assuming that the whole underlying agreement is not made conditional on the issuing of the documentary credit, and,

²¹⁷ Oelofse, 68-70.

²¹⁸ Ibid., 70.

²¹⁹ Todd, 61-62.

also assuming that the provision concerning documentary credit is a duty undertaken by the buyer in terms of the underlying agreement, the seller still runs the risk of the buyer defaulting on the issuance of the documentary credit. Clearly that would amount to a breach of contract leading to the ordinary remedies determined by the legal system governing the underlying agreement.²²⁰ What those remedies are cannot be explained thoroughly in this paper but following the example set by Oelofse, it may be worthwhile mentioning a few legal systems and possible remedies available to the seller under those regimes.

Under the German law the seller is often able to cancel the contract immediately and claim for damages. Furthermore, where immediate cancellation is not available to the seller, a right to cancel can be acquired by setting a further reasonable period for performance by the buyer.²²¹ In English law the seller will always have the right to cancel if the buyer defaults. This is due to the fact that time is always of the essence of the contract with respect to the time for the opening of the documentary credit.²²² Some consideration should also be given to the effects that the United Nations Convention on Contracts for the International Sale of Goods (CISG) may have on the contractual duty to issue a credit and especially on the remedies available to the seller in case credit is not issued according to the underlying agreement, a conduct amounting to non-performance on the part of the buyer.

The CISG applies, according to its provisions, to contracts of sale of goods between parties whose places of business are in different states either, if those states are parties to the Convention or, if the rules of private international law lead to the application of the law of a contracting state. From the point of view of the exporter, article 64 of CISG will determine his right to cancel the contract as the result of a default on the side of the buyer. It follows that the same article shall also be applied in situations where the buyer has failed to have the documentary credit issued within the agreed time. According to the provisions of the Convention it seems that the seller is allowed to cancel the contract if the breach of the contract

²²⁰ Oelofse, 71.

²²¹ Right to immediate cancellation is found in paragraph 361 of the German Civil Code and paragraph 376 of the German Commercial Code. Acquired right to cancel by setting a further period for performance is situated in paragraph 326 of the German Civil Code.

²²² Oelofse, 71.

amounts to a material breach.²²³ Under CISG, a material breach is defined as a breach which '...results in such detriment to the other party as substantially to deprive him of what he is entitled to expect under the contract, unless the party in breach did not foresee and a reasonable person of the same kind in the same circumstances would not have seen such a result'²²⁴. Oelofse defines the provision mentioned above as 'rather vague' and one has to agree that the rules of the jurisdiction will most likely come into play and be nevertheless applied to determine exactly to which remedies the seller is entitled to and as a part of that determination, if the failure to furnish the documentary credit in time can be regarded as a breach entitling the seller to cancellation.²²⁵ Furthermore, if it is decided that this particular failure on the part of the buyer does not amount to a material breach, the seller is always entitled to set a further reasonable period for performance by the buyer, and may then cancel if this period also lapses without performance by the buyer.²²⁶

As it has been noted above, it is submitted that if the buyer causes the issue of a documentary credit which is not in accordance of the credit clause, he clearly commits a breach of contract. The same principle applies in cases where the seller has not had any credit issued despite of the clause stipulating for such as the method of payment. Furthermore, it can be argued that the party to a contract is always responsible for the actions or omissions of any such person whom he uses to comply with his contractual obligations and therefore the actions of the issuing bank fall within the buyer's scope of responsibility. It follows that a failure by the issuing bank to issue the credit according to the instructions it has received from the buyer (applicant) does not excuse him and that failure must be regarded as a breach of contract. Naturally if the buyer, after he has undertaken to do so, is unable to find a bank which would be willing to issue the credit, he will not be able to use this as his defence.²²⁷

The situation is likely to change when the issuance of the credit is rendered impossible by exchange control restrictions issued by the authorities in the buyer's locality. In this particular

²²³ CISG, Art. 64.

²²⁴ Art. 25.

²²⁵ Oelofse, 81.

²²⁶ CISG Art. 64(1)(b).

²²⁷ Oelofse, 75.

scenario one must differentiate between restrictions which were in force and therefore known to the parties before the conclusion of the underlying contract and, on the other hand, those restrictions which have been introduced only after the parties entered into their contractual relationship. In addition to these characteristics, it is also necessary to define whether the restrictions set by the state are absolute or if they possibly are subject to a permission.²²⁸

In cases where the exchange restrictions have already been in place by the time of concluding the contract and if those restrictions are absolute, it must be clear that due to the fact that payment is rendered impossible by a factor that was known to both of the parties, the contract must be considered void and the obligations of the parties dissolved. On the other hand if the restrictions were similarly in existence during the time of signing the contract, but it is nevertheless possible to have a permission granted by the authorities in order to effect payment, the situation is different to the one mentioned above. Oelofse argues that in this particular scenario, assuming that the contract is not made conditional on the granting of the necessary permission, '...the buyer impliedly undertakes that the permission will be given. In other words, if the permission is not obtained, he still brakes his undertaking to supply a letter of credit, and the court could still award damages against him.'²²⁹

As long as the restrictions are imposed only after the contract was concluded it is clear that the buyer has not had the possibility to take that particular act of the authorities into account and therefore, the impossibility of his performance could not have been foreseen by him. It follows that the restrictions imposed after the conclusion of the underlying contract must be regarded as supervening impossibility of performance which may lead to the dissolution of the obligations of both parties. It is however possible for the parties to keep the contract alive by a modification of the payment clause. For the seller this would mean waiving the security of the documentary credit by signalling his willingness to be satisfied with other means of payment.²³⁰ Logically, the possibility to keep the contract alive by discarding the credit clause exists only if other methods of payment are not included in the scope of the imposed restrictions.

²²⁸ Oelofse, 78.

²²⁹ Ibid., 76.

²³⁰ Ibid., 77.

An opinion has also arisen, according to which the impossibility to issue the documentary credit does not lead to the dissolution of the contract but rather affects only that part of the contract which stipulates for the issuance of the credit as the payment method ie. the credit clause. The contract would then accordingly be transformed into a contract which stipulates cash payment against the delivery of the prescribed documents by the seller.²³¹ Assessing the situation from the point of view of the seller, one must agree with Oelofse on his opinion that this approach should not be accepted due to its imminent risks to the seller. In this situation the seller would have to automatically accept a payment method far less secure than a documentary credit without having any choice in the matter. If the contract was simply transformed, the seller would be put under an obligation to ship the goods without the security that possibly was a prerequisite for him when entering the underlying agreement.

4.9 The issuance of the credit and it's effect on buyer's payment obligation

Advancing chronologically in the process of obtaining payment securely under a contract that provides for payment by means of a documentary credit, one comes across the question of the effect that the issued credit might have on the actual contractual obligation to pay undertaken by the buyer. This problem may arise under various circumstances and the answer to that question naturally has extreme importance to the seller considering his payment risks. In cases where the seller, for what ever reason, is not in fact paid trough the credit, the practical relevance of the issued credit becomes clearly focussed. Additionally one may question the reasons of the default in payment and furthermore whether these reasons in fact have an effect in this context. It may well be that the seller has not been paid under the credit due to the fact that the bank responsible for the credit has gone insolvent or, because the bank for some other reason chooses to dishonour it's obligation. In these situations it is assumed that the seller himself has fulfilled his contractual obligations ie. presented confirming documents during the validity period of the credit. However, the situation may also be such that the documents tendered do not confirm or they are presented after the expiry date and therefore it is the seller himself who is at fault for not getting his money. The scenario mentioned first is discussed in this connection and the latter one, where seller is to be blamed, will be looked at when assessing situations where seller is not able to comply with the requirements of the credit clause.

²³¹ Oelofse, 77.

There is a healthy amount of case law and controversy to be found around this subject, but the opinions of courts and scholars seem to have settled on the view that the issuance of a documentary credit does not constitute a payment under the agreement on which it is based.²³²

The meaning of this is that the payment obligation undertaken by the buyer is not terminated by the time he fulfills his obligation to have a credit issued. In this sense, the documentary credit is merely a mechanism of payment stipulated by the underlying agreement and which the seller has to make use of when obtaining payment. It follows that during the period of validity stated in the credit, the claim for the purchase price on the underlying contract is merely suspended.²³³

This principle has been codified by the American Uniform Commercial Code where it is stated that the delivery of the proper letter of credit suspends the buyer's obligation to pay, and furthermore, the Code provides that in cases where the letter of credit is subsequently dishonoured, the seller is allowed to require payment directly from the buyer.²³⁴ The German approach seems to be along the same lines. In Germany, it is submitted that the issuing of the credit only takes place in order to facilitate the payment as was set out in the underlying agreement, but not in substitution of the payment obligation.²³⁵

The notions above lead to the conclusion that whilst the payment obligation under the underlying contract is suspended, it is not possible for the seller or the buyer to 'short-circuit' the credit. From the sellers point of view this has the effect that he is not allowed to demand payment from the buyer by any other means and, that he does not have to accept payment in any other way than by documentary credit. Naturally, it is within seller's discretion to allow the buyer to effect payment for example in an advance cash payment even though the contract stipulates for payment by documentary credit. This however, is not short-circuiting of the credit but rather transformation of the contract taking place with the consent of the seller.

²³² Ellinger at 531. According to his studies this approach is 'common ground' in the USA, France, Germany and England.

²³³ Oelofse, 91.

²³⁴ UCC section 2-325(2).

²³⁵ Oelofse, 96. He also argues that German terminology used in this context makes a clear distinction on this issue due to the fact that the term 'Erfüllungshalber' is used and not 'an Erfüllungs Statt'.

The employment and issuance of a documentary credit also has another interesting characteristic what comes to the relationship between the seller and the buyer. Clearly, the seller's claim for payment from the bank is, as mentioned before, independent of any actions or defences that may arise regarding the underlying agreement. From that follows that the seller's security to obtain payment from the bank is not affected by any right of the buyer to set-off a claim he may have against the seller. In addition to that it could be argued that the buyer cannot rely on a set-off even in those cases where the seller, after not being able to obtain payment from the bank, looks to the seller for his moneys.²³⁶ According to Oelofse and his commentary on a German Federal Court decision, this may be the case at least in situations where the buyer's actions or omissions are the reason due to which seller has not been able to obtain payment from the bank.²³⁷

As a whole, it appears that the issuance of a documentary credit does not affect seller's security of payment in any way negatively due to the fact that his rights for recourse are intact even after the credit has been issued. The fact that the seller's right to payment under the contract of sale is suspended does not increase his payment risk since he 'reclaims' those rights if payment for some reason is not made from the documentary credit. It also seems that these rough principles apply in both common law and civil law jurisdictions. Worth pointing out is the fact that the situation regarding seller's right to recourse may, and is likely to change in the odd situation where the contracting parties have specifically agreed that the issuance of the credit shall constitute absolute payment.

4.10 Right to payment

4.10.1 Complying documents

As long as the seller is able to comply with the requirements of credit he will be on the safe side due to the fact that the bank has then no other option than pay or face legal action by the beneficiary. Should the bank default, the seller has the option of recourse against his buyer. In case the credit is confirmed, the seller is able to take recourse against the buyer immediately or

²³⁶ Oelofse, 98.

²³⁷ Ibid.

alternatively demand payment from the issuing bank first. The situation of the seller changes if he is not able to present the required documents in the period of time allowed by the credit. When the seller tenders the correct documents but only after the credit has expired it is not possible for him to obtain payment from the bank without the authorisation of the buyer. It is in the buyer's discretion to allow payment against late presentment and he has no obligation to so. Even if the seller is not able to timeously tender the documents, his right to be paid under the underlying contract still remains although late presentment constitutes a breach of that contract and entitles the buyer to claim damages from the seller. However, the right to payment falls naturally away in cases (jurisdictions) where late presentment of the documents is considered serious enough to entitle the buyer to cancellation. An advice worth thinking about regarding sellers that have fallen behind their shipping schedules is given by Moses when she comments: '...if the seller learns that the date for shipping goods cannot be met, he should not ship any goods until he obtains an amendment to the LC permitting later shipment'.²³⁸

The issuing bank (and the confirming when one exists) has by issuing a documentary credit bound itself to an irrevocable undertaking to effect payment to the beneficiary of the credit subject only to the conditions of the credit itself. Here, the bank does not have very many options; it either takes up the documents and pays the beneficiary or, it refuses the tender and does not pay. It follows from the principle of independence that the bank's obligation to effect payment will be triggered if the seller is able to produce documents that are in conformity with the requirements of the credit and to tender those documents in time ie. during the validity of the credit and the period allowed for shipping. In principle the seller will not be able to obtain payment from the bank only if he cannot comply with those requirements spelled out in the credit. Any defence that the buyer may have against the seller or, in fact any other factor that lies outside the scope of the credit does not affect the relationship between the seller and the bank due to the fact that rights and obligations in that particular relationship stem from the credit itself and its stipulations. However, it is clearly to be seen in practice and in *opinio juris* that the principle of independence cannot be regarded as entirely inflexible and unaffected what comes to the circumstances surrounding the credit transaction.

²³⁸ Moses, 3.

Clearly, any defences, but particularly those that originate outside the documentary credit, that have an effect on the independence principle, undermine the security of the credit and in the same vain the payment security of the seller. However, in the words of Hugo '...it must be borne in mind that the UCP is of very limited assistance in this area [and that] the resolution of these matters is largely, and purposely, left to the different national legal systems'²³⁹ and therefore fall outside the scope of this paper and are largely left out of it.

Worth mentioning is the fraud exception to the independence principle which is clearly accepted as an exception to the otherwise strictly enforced autonomy of the credit. In both common and civil law systems it is accepted that fraudulent actions by the beneficiary may offer a defence that allows the bank to refuse payment to the beneficiary. The definitions and characterisations of this exception vary from jurisdiction to the other, but again from the point of view of a bona fide seller it should be mentioned that it is widely accepted that the deficiencies of the goods (quality, quantity or kind) per se will not entitle the bank to refuse payment.²⁴⁰

4.10.2 Non-complying documents

Under the Uniform Customs and Practice for Documentary Credits²⁴¹ the issuing bank or the confirming bank has two obligations when it receives the documents submitted by the seller in order to obtain payment. Firstly, it is under a duty to examine those documents with reasonable care to determine whether they in fact conform with the terms of the credit. The second obligation is to decide it's course of action if discrepancies are found.²⁴² To fulfill the first of these, the bank has a reasonable time which however, may not exceed seven banking days, following the day of receipt of the documents, to examine the documents and whether to take up or refuse them and to inform the party accordingly.²⁴³ If the documents are found not to be in

²³⁹ Hugo, 251.

²⁴⁰ Ibid., 260.

²⁴¹ UCP, Art. 13(a) and 14.

²⁴² Buckley, 5.

²⁴³ UCP, Art. 13(b).

compliance with the terms of the credit, it is in the banks discretion to approach the buyer (applicant) for a possible waiver of the discrepancies.²⁴⁴

A provision of the UCP that one should notice in regard of the date of presentation of the documents is the Article 43 which states that documents must not be presented in any event after the expiry date of the credit but it also states that if no time period after shipment is given in the credit for presentation of documents, banks are not allowed to accept any documents tendered to them later than 21 days after shipment. This has in some cases the meaning that even if the credit allows, in terms of the expiry date, more time to than 21 days for presentment of the documents after the shipment, the seller must tender then accordingly to Art 43 in 21 days from the shipment if the date(s) of presentment is not defined.

As it has been mentioned earlier, the seller should plan the transaction in such a manner that the expiry date of the documentary credit allows sufficient time to permit correction of any mistakes in the documents. In cases where discrepancies can be corrected, the seller must do so before the original expiry date of the credit. Since a large part of international sales of goods contracts are governed by the CISG, a relevant provision of the Convention in regard of the presentation of the documents must be looked at. The Convention namely allows the seller a right to rectify non-conforming documents before the last date for the presentation of documents. According to the Convention a seller who has tendered documents before the last date of presentment has the right to cure any lack of conformity in the documents before that time.²⁴⁵ Therefore, even if the presentment of non-complying documents as such would entitle the buyer to cancel the contract, he now is unable to do so during the period the seller has the right to cure the non-conforming documents.²⁴⁶

If however, the situation is such that discrepancies in the documents cannot be rectified and the buyer is not willing to amend the credit or waive any discrepancies in it, the seller then is unable to fulfill his part of the underlying contract of sale from which the immediate consequence is that he will not be able to obtain payment from the bank. The seller is in default towards the

²⁴⁴ UCP, Art. 14(c).

²⁴⁵ CISG, Art. 34.

²⁴⁶ Oelofse, 82.

buyer in terms of the contract of sale and depending on the jurisdiction the buyer is entitled to claim damages and perhaps even cancellation of the contract.

It is also possible that the documents over which the parties have agreed and that are now included in the credit as a prerequisite for payment cannot be complete without a contribution from the buyer, for example in situations where '...the purchaser reserves the right to issue forwarding instructions but refrains from doing so when it becomes necessary'.²⁴⁷ If seller in these circumstances is unable to present complying documents or is alternatively delayed so that presentment cannot be made timeously, clearly the buyer then is in default towards the seller.

Whether the buyer still remains liable to pay the purchase price stipulated in the underlying agreement even if the seller has not been able to fulfill his contractual obligations naturally depends on the laws of the jurisdiction and especially the facts of the particular case.

4.10.3 Non-documentary conditions

The documentary credit may well, as it is reasonably common, require the seller to do something that obviously cannot be proven by a document relating to that fact. Other possibility is when a certain condition does not specify any documents to be presented in compliance with it.²⁴⁸ Is the seller required to comply with a provision in the credit which might state that 'the goods are to shipped on board a ship that is above standard and furthermore, does not fly the flag of a conveniency register'? This and other requirements in such manner, if enforceable, would clearly erode the security of payment of the seller. To accept a requirement which is not to be proved by any particular document on presentation would violate the principle of independence of a credit due to the fact that the bank where documents ought to be presented is then drawn into the realms of the underlying agreement of sale. The problem of non-documentary conditions has been dealt with by the drafters of the current UCP and it also came up in the revision process of the article 5 of the UCC.²⁴⁹

²⁴⁷ Schiller, lectures.

²⁴⁸ Hugo, 122.

²⁴⁹ Ibid., 123.

It goes without saying that a seller should be aware of the difficulties related to these conditions and therefore, should not agree to anything that imposes to him obligations that are difficult to fulfil. This is, of course, the policy that the seller should follow in general in documentary credit operation and not just regarding to non-documentary conditions. It seems that on both occasions (UCP & UCC) when this question was attended to, the drafters went through different possible solutions to the problems, but in the end concluded that non-documentary conditions should and may be simply ignored due to the fact that this approach allows for 'conceptual simplicity and operational ease'²⁵⁰ The conclusion of the UCP drafters is clearly to be seen in the Uniform Customs where it provides that 'If a credit contains conditions without stating the document(s) to be presented in compliance therewith, banks will deem such conditions as not stated and will disregard them'.²⁵¹

The conclusion then is that a non-documentary condition included in the credit itself will not prevent the seller from obtaining payment from the bank even if he is not able to produce proof that the duty put on him by that particular provision has been fulfilled. However, the seller will nevertheless be liable to the buyer in terms of the underlying agreement and under the particular law governing the contract of sale. It follows then in terms of the example given earlier that a seller, who ships the goods on a sub-standard vessel flying the flag of a convenience registry, will get his money from the bank but is also in breach of the underlying agreement towards the buyer and must face possible consequences of that default.

4.10.4 Abusive defences by the buyer

Considering the frequency of discrepancies and the unbelievably high failure rate of first presentations which seems to vary between different jurisdictions, but is settled globally between 50 to 90 percent²⁵² of first presentations, the seller may find himself in the unenviable situation where he is not able to rectify the discrepancy in the documents and the seller, for bona fide or mala fide reasons, is not willing to waive those particular discrepancies. It may well be that the discrepancies in the documents, in buyer's opinion, testify that the seller has not

²⁵⁰ Hugo, 123.

²⁵¹ UCP, Art. 13(c).

²⁵² Schmitthoff, *Journal of Business Law*, 1987 at 94-97.

fulfilled his contractual obligations but, it may as well be that the market in the buyer's locality has fallen and due to these changes in his environment, he can no longer be certain that the contract between him and the buyer is as profitable as he hoped it would be. The UCP tries to cope with this sort of 'technicality escape' of the buyer when it provides the words 'about', 'approximately', 'circa' or similar expressions used in connection with the amount of the credit or the quantity or the unit price are to be understood as allowing a difference not to exceed 10% more or less than the amount or the quantity or the unit price to which they refer.²⁵³ Furthermore, the Uniform Customs state that unless a credit stipulates that the quantity of the goods specified must not be exceeded or reduced, a tolerance of 5% more or 5% less will be permitted.²⁵⁴ The same reasoning is behind the Article 20 titled 'Ambiguity as to the issuers of Documents', which, in protection of the buyer and to simplify matters, provides that terms such as 'first class', 'well known', 'qualified', 'independent' etc. should not be used to describe the issuers of any documents to be presented under a credit. These provisions, however may be of little assistance where the seller has allowed some sort of technicality escapes to be built in to the credit during contracting for the underlying contract. It follows that the most reliable way to avoid these problems is to have as clear and unmistakable provisions in the credit as possible without undermining its functions.

4.11 Documentary credits and seller's payment risk exposure

As a short conclusion to the discussion regarding documentary credits and the possibilities that the seller has to control the operation when contracting for the underlying agreement on which the credit then is based, one could say that a documentary credit offers unbeatable security for the seller where such security is needed, assuming that the seller is aware of the pitfalls of the credit when embarking on negotiations for a credit clause. A documentary credit operation must be controlled beforehand by the seller as said, during contracting, due to the fact that it is hardly possible to affect the process and the provisions of the credit without the consent of the parties involved after the issuance of the credit. Once the seller has negotiated a credit clause which includes only such provisions that he knows he can comply with, he then is relatively safe and may expect to be able to fulfil his contractual obligations and most importantly, to be paid.

²⁵³ UCP, Art. 39(a).

²⁵⁴ Ibid., Art. 39(b).

The process of agreeing the terms for the credit, issuance and presentation of the documents has already been discussed earlier and it is sufficient to mention in this context that to reach the most beneficial position for the seller, the operation should be kept as simple as possible, especially what comes to documents against which the seller will obtain payment. If possible, the seller must not agree to any documents that he will not be able to produce without the co-operation of the buyer and in cases where this cannot be avoided, the seller can always demand that the payment will be available against some alternative document instead, in case the buyer refrains from producing the document needed.

Furthermore, the pros and cons of different types of credits have been laid out earlier and only the core of that discussion is mentioned here. Revocable credits do not offer any security to the seller and should not be used. Whether the credit is to be issued unconfirmed or confirmed is entirely a question that, in order to be answered, requires knowledge of the particular transaction. However it should be mentioned that, as said already earlier, confirmed credits are not a absolute necessity due to the fact that obtaining one is relatively expensive and in certain circumstances the confirmation may not add anything to the security of the seller. Situations which come to one's mind, where this might the case, are of course those where the credit has already been issued irrevocable by a world-class bank. If the seller does not have confidence in the bank that has issued the credit or the political stability of the country where it is situated, he should go for a confirmed credit. In cases where the issuing bank is not able to have a documentary credit issued by it confirmed, the seller is wise to consider once more whether or not to embark on the particular transaction.

A documentary credit operation is not a foolproof method to avoid the payment risk but nevertheless, it is a very useful tool when the person using it is knowledgeable of the objectives that he wants to achieve by using such device and furthermore, knows how to avoid the problems that are imminent during the process. Most important factor in my opinion is to understand the importance of the credit clause forming a part of the whole underlying agreement of sale. The drafting of that particular contract clause has an impact on the whole process and therefore most of the risks that might prevent the seller from getting paid can be avoided during this phase, whereas reacting to problems that may occur due to careless attitude towards the payment clause is always more difficult.

Chapter 4 - Conclusions

Four primary methods of exchanging goods for payment are used in cross-border business transactions. These methods have been discussed earlier, and range from open account payments to payments in advance. Each of the four methods have their advantages and disadvantages, depending on, from which point of view one looks at the question. Assessment of transactional risks can clearly not be complete without the assessment of risks involved in effecting payments. From the risk exposure point of view, methods of payment have often been described as a 'risk ladder'²⁵⁵ using which, sellers reduce their exposure to payment risk as they descend the ladder, moving from open account towards cash in advance.

Clearly, this is the way risks involved in different methods must be understood by an international seller. However, it should be pointed out that the costs of a payment mechanism run in the opposite direction on that particular ladder and it is the combination of these two factors, namely the risks and the costs of managing those risks, that come into play when making decisions. Naturally, the optimum position for the exporter is a situation where he is able to use a method that offers him sufficient flexibility on the market and furthermore, acceptable degree of risk exposure.

When those two pre-requisites mentioned above are combined in the context of the four primary methods of exchanging goods for payment, one is able to arrive in a conclusion where the mechanisms of payment display themselves, not as a 'ladder', but more as a 'toolbox' in which there is a proper device for every situation. Acknowledging the fact that all payment methods have several variations among themselves, it should be added that the 'toolbox', in addition to what is said above, includes a number of variations of every tool, enabling an exporter to have a healthy amount of options when embarking on a transaction.

Using different methods of payments is a good mechanism of reducing exporter's payment risks. All of them however, have their pitfalls and to be able to avoid them, one needs sufficient knowledge of the workings of the four methods and the environment in which the transaction is taking place.

²⁵⁵ For example in Luxon: How do I get paid?... At 1.